The Manufacturers Hanover
Economic Report

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Quarterly Business Conditions Analysis

Returning recently from a lengthy business trip, I felt like Rip Van Winkle reincarnated. Washington Irving's legendary character, you may recall, went to sleep one day and did not awaken until 20 years later. When he did, he quite naturally found the world significantly changed from the way it was when he last was awake.

When I embarked on my trip, the business climate was dreary and getting worse at an alarming pace. In an effort to dampen inflation and the expectation of inflation, the Federal Reserve had earlier slammed on the monetary brakes, sending interest rates soaring to record levels and causing consumers to cut back their spending severely in the mistaken belief that credit was no longer available. Needless to say, this caused the "real" gross national product in the second quarter to contract by an annual rate of 9.1 per cent—equal to the worst quarterly decline in the postwar era recorded in first-quarter 1975.

Not surprisingly, many economists, including myself, became alarmed at the rate at which the economy was descending. There were widespread calls for changes in the policy mix, ranging from my recommendation that the Federal Reserve take its foot off the monetary brakes (by removing credit controls and increasing the growth rate of the money supply), to others' views that the government should also step on the fiscal accelerator by cutting taxes and/or increasing spending. Judging by the way the economy appears to be behaving now, I think that the release of the Fed's foot from the monetary brakes may well turn out to be enough. Maybe it's the "Rip Van Winkle" effect, but I detect a distinct change in the economic climate in only about a month's time.

This is not to imply that I think the recession is over, and from here on out the U.S. economy will be expanding. I still believe that we've got several quarters left of economic decline ahead of us. But in terms of the magnitude of the decline as well as the major contributors to it, things will be different in the second half of the year than they were in the second quarter, so you should factor this into your decision-making.

Seeds Of Recovery

Like the plants around the Washington State volcano, Mount St. Helens, that began pushing their way through the ash soon after the eruptions, the seedlings of future economic recovery are popping up now in the wake of the devastation wrought by the second quarter's steep drop in economic activity. For one thing, as consumers stopped spending, they paid off a large chunk of their installment debt and began to rebuild their savings. The decline in consumer credit outstanding in April and May, $5.4 billion, along with the upturn in the second quarter's savings rate to 4.7 per cent from 3.7 per cent in the first quarter, has gone a long way toward returning the consumer's balance sheet to normal.

Ordinarily, such a restoration might have taken several quarters to accomplish, thus prolonging the period during which consumers would stay out of the marketplace. Under those circumstances, of course, business would cut back its operations, laying off workers and adding to the intensity and the duration of the recession. But because many people misunderstood the Fed's credit restraint program, thinking no credit was available at all and that existing obligations should be paid down ahead of schedule, they accomplished this restoration in a matter of months —if not weeks. Thus, when the inevitable price cutting that always follows an unintended buildup of unsold goods got underway, people were able to take advantage of these discounts and step up their pace of spending almost immediately.

You could see this cautious return toward spending in some recent statistics. Sales of single-family homes rose in May compared with April, seasonally adjusted, after having fallen during the previous three months. New-car dealers reported that sales in June did not fall any further from May's levels, sea-

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sonally adjusted—while they actually picked up a bit in early July. The Commerce Department says that housing starts rose sharply in June compared with May, seasonally adjusted, while permits issued for future new-home construction advanced for the second month in a row. Finally, total retail sales advanced in June, both in current dollars and after taking out the effects of inflation.

Much of this change in the economic climate traces to another development that accompanied the steep drop in economic activity: a sharp and unprecedented decline in interest rates. At one point, such key money market interest rates as those on three- and six-month Treasury bills were down ten percentage points from their peaks reached just several months earlier. Such a steep decline has several implications. For one thing, as representatives of the entire spectrum of short-term interest rates, these declines are indicative of an improved availability of credit at lower cost. Obviously, this makes borrowing easier for businessmen and consumers.

In particular, the drop in Treasury bill rates helped the thrift industry by reducing the incentive for people to withdraw their funds from savings accounts and invest them directly in money-market instruments. Known as disintermediation, this process has afflicted the mutual savings banks and savings and loan associations at this point in every postwar business cycle, drying up the funds they have for making mortgage loans. I would not assert at this time that the thrifts are either willing or able to get back into the mortgage-lending business in a big way, but the early reports of renewed deposit inflows, along with the development of such new instruments as the five-year renegotiable mortgage suggest that some further improvement in the pace of residential construction lies ahead.

By taking its foot off the credit brakes in the form of dismantling its program of selective credit controls, the Fed has gone a long way toward helping moderate the economic decline. Early evidence suggests that retail sales are beginning to benefit from the consumer's renewed access to credit. Needless to say, these are largely big-ticket items—the very goods that suffered severely because of earlier cutbacks in consumer spending, then were aggravated by the Fed's credit controls. While rising unemployment may generate continued caution with regard to spending, I think that the renewed availability of credit will begin to tempt people to return to stores to take advantage of the growing number of bargains that is developing as merchants discount prices in an effort to move unsold goods.

This tendency to cut prices has produced a noticeable slowing in the rate of inflation. After rising at a compound annual rate of nearly 17 per cent in the first quarter, consumer prices went up at a more moderate 13½ per cent clip in the second quarter. From the point of view of spurring consumer spending, this slowing of inflation (with some prices actually falling) could not have happened at a better time. This is because the consumer, increasingly aware of the existence of recession, has adopted a new posture distinctly different from the one that he and she have held for the previous two years.

Consumers Change Their Minds

Throughout most of 1978 and 1979, the prevailing attitude among many consumers could best be characterized by the phrase, "buy now before prices go up later." Originally encouraged by the speed with which prices of new cars and new homes went up in spring, 1978, this attitude soon spread to purchases of other goods as people concluded that the government was either unwilling or unable to do anything substantive to slow the rate of inflation, and thus their only recourse was to buy goods before their prices went up. However, the process of buying to beat higher prices must eventually result in people outspending their income flows, causing a cutback in savings. Nationwide, the savings rate plunged from five per cent in 1978 and the early part of 1979 to nearly three per cent by the end of last year. This represented a low equalled only during the early stages of the Korean War, when people rushed to buy goods fearing a repetition of the widespread shortages that characterized World War II.

Many people soon found it expedient to go heavily into debt. They evidently figured that, besides the "benefits" of buying before prices went up, they would be repaying their loans with dollars cheapened by inflation and that the interest rate incurred was a tax deduction, further reducing the effective cost of borrowing. Needless to say, the typical family at yearend 1979 found itself saddled with an unprecedented amount of debt relative to its ability to repay.

At the turn of this year, consumers shifted to a mood of retrenchment in an effort to shore up their savings and reduce their debt burden. This turned into a "buy later" attitude when people saw the effects of the Fed's March 14 policy of credit controls on their own purchases in particular and on the U.S. economy in general. Remembering what happens in every recession, but encouraged especially by the rebates announced by the domestic automobile manufacturers as well as some foreign-based producers, the decline in mortgage interest rates and, subsequently, in new-home prices, people started actively seeking off-price sales among a wide variety of goods and services. By the end of the second quarter, these expectations had begun to bear fruit. As merchants responded to the pileup of unsold goods by slashing prices, consumers responded by returning to stores, producing the rise in retail sales for the month of June that I referred to earlier.

Thus the next few months are likely to bring a dramatic improvement in the inflation rate—at least as measured by the consumer price index. For one thing, recessions always have their effect on inflation for reasons I mentioned above: the widespread discounting that appears whenever unsold goods pile up. This time is no exception, but another reason will be more technical in nature, and that is the way the consumer price index is put together. As should be well known by now, the CPI gives disproportionate weight to new-home prices and mortgage interest rates. When these go up, as they did rapidly from 1978 through the first quarter of this year, they add unduly to the consumer price index, which, in simplistic terms, assumes that everyone buys a new house each month and pays the current mortgage rate to finance it.

Now that mortgage interest rates are falling and housing prices are coming down, there will be a disproportionate downward pull on the CPI, giving the impression that the rate of inflation is slowing. In addition, the consumer price index uses fixed weights, causing energy prices, a fast riser during the last couple of years, to impart more of an upward bias to the CPI than they should have. Because of the aftereffects of the steep rise in energy prices last year as well as the recession, energy supplies have become abundant and retail prices have come down a bit. This, too, should disproportionately slow the rise in the CPI.

Food prices were set to exert a similar downward pull on the CPI until Mother Nature intervened. The well-documented spell of dry, hot weather in the nation's farm belt has taken its toll on many agricultural commodities. It has killed chickens, forced cattlemen to dump their animals onto the market, withered cotton and is beginning to affect the nation's major feed-grain crops. Some retailers already report having to pay higher prices for many types of foods, a situation that undoubtedly will be reflected at the consumer level before very long. In other words, a faster rise in food prices seems likely to moderate some of the downward pull on the CPI exerted by the forces of recession in general and energy and housing in particular. Still, the consumer price index could rise at rates as "low" as 5-6 per cent for at least a few months in the near future before going up more rapidly once again as the economic slide draws to a close.

Inventories Are Swollen Again

When it comes to assessing the position of business inventories, there is much confusion. Inventory data are usually the least reliable of those produced by the government. This is especially so at this point in the business cycle, because current high rates of inflation impact unevenly on inventories and sales. Not too long ago it was fashionable to point out that inventories were in good shape relative to sales, even though the economy was slowing, because the current-dollar ratio of inventories to sales was historically low. However, this has changed in the wake of the steep decline in sales in the past few months. For all business the current-dollar ratio of inventories to sales is now at its highest point since 1976. In "real" terms, taking out the disparate affects of inflation on inventories and sales, the situation is even more worrisome. The I-S ratio for total business is almost as high today as it was during the worst part of the 1973-75 recession.

This may seem to go counter to the prevailing wisdom. Many people would agree that, while there is, indeed, an unintended pileup of inventories, there is not present today the deliberate building up of inventories that occurred in the last cycle. I have no doubt that businessmen have been cautious these past couple of years with regard to inventory levels, since they were given considerable advance notice of this recession and had still in their minds the painful memories of the effects of the deliberate buildup that they undertook during the first half of the last recession. However, I would submit that the real ratio of inventories to sales is as high as it is today because businessmen are once again being misled by inflation, since it affects sales and inventories at different rates of speed.

What this means is that, intent notwithstanding, there exists a substantial overhang of real unsold goods to real sales. This will have to be worked down in the coming months before output can be expected to turn around and rise. Accordingly, you should anticipate that business, through its inventory-reduction policies, will be responsible for the bulk of the economic declines from here on out, in distinct contrast with the downward pull caused by the consumer earlier this year. However, this does not mean that the economic declines likely to occur the current quarter and the fourth quarter will match the second quarter in intensity since, as I pointed out above, the consumer is already back in the marketplace hunting for bargains. This process will aid businessmen on all levels of production and distribution in working down their inventories.

To be sure, the real inventory-sales ratio is a lagging indicator. This means that it usually continues to rise well after a recession comes to an end. In the present circumstance, this suggests that inventory liquidation could continue for some time to come. However, it should be pointed out that changes in the economic climate have occurred with unprecedented swiftness in the current cycle. For example, after rising rapidly late in 1979 and in the first three months of this year, short-term interest rates subsequently fell with equal vigor; after taking on debt at an unprecedented rate late last year and early this year, consumers paid down debt at record-breaking

rates of speed; the drop in many key economic statistics (and the rise in unemployment) was unprecedented in modern times; and the rate of inflation has been cut substantially in the space of three months. What I am saying here is that the inventory-sales ratio could fall just as swiftly as it has gone up because of the combination of increased consumer buying and rapid declines in output. If so, it would reduce the time needed to get stocks in line with sales.

With automobiles and housing now on the way up, and retail trade in general likely to experience increases before too many months go by, it would seem that the economy should reach its nadir around yearend. Thus, 1981 should, by and large, be a year of expanding economic activity. However, lest you get your hopes up high, let me go down on record as saying that I do not believe that the expansion, when it comes, will be all that noticeable because it will not be all that sharp.

The Rebound Will Be Mild

There are several reasons for this. In the private sector, the consumer, having satisfied his and her demands for goods ahead of schedule for the last couple of years is likely to return to a more normal pace of buying in the next couple of years. The demographics of the population may suggest that there is pent-up demand for autos, housing and other big-ticket items, but the very nature of these goods (their postponable quality) makes it difficult to predict flatly when these pressures will generate a renewed burst of spending.

On the business side, because capacity utilization has sunk so low and because large sums of money still must be earmarked for such noncyclical purposes as cleaning up the environment, making plants safer for workers and goods safer for consumers, and because the tax structure continues to weigh against capital formation, business is unlikely to embark on a capital spending boom any time soon. On the monetary side, the Federal Reserve at best will follow its recent path of keeping the growth in the money and credit aggregates to a rate which over the long run would tend to squeeze down inflation. At worst, the Fed could return wholeheartedly to its policy of managing money-market interest rates which, given present depressed conditions, would tend to keep the supply of money and credit growing even more slowly, thus putting more of a lid on the eventual economic rebound.

It is on the fiscal side that the greatest restraint is likely to occur. Right now there is much discussion of the need for a tax cut. Such discussions are not hard to understand, since cutting taxes puts more money into people's pockets, presumably encouraging them to increase their outlays, thus ending the recession. However, because of special circumstances that prevail at this time, there is a need to distinguish between actually cutting taxes and simply reducing the tax burden. For unless taxes are cut by substantially more than is now being discussed, the actual tax burden on most people will rise significantly in 1981.

There are several reasons for this. The first is the fact that inflation pushes us all into higher tax brackets. Since our tax structure is "progressive," a higher tax bracket means a higher tax rate (percentage of income). With no change in present tax rates, the upward warp brought about by inflation will produce an extra $20 billion in Federal revenues next year. Then there is the projected increase in Social Security taxes. Under present law, Social Security taxes will go up by $17 billion on January 1. The reason for this rise is that Social Security taxes must cover the increased benefits that the system pays out, and benefits have risen sharply in recent years because they are indexed to the rate of inflation. Add to this the $15 billion or so that the government is likely to take in next year because of the "windfall" profits tax on the oil companies, and you come out with an increase in the tax burden exceeding $50 billion, if present laws remain unchanged.

This kind of tax increase would restrain significantly the economy's ability to recover from today's recession. It might keep unemployment high for a considerable period of time and sales and profits sluggish. However, if there are signs that the recession has bottomed out by the turn of the year and a recovery is underway, policymakers might be wise to avoid cutting taxes at all. This is because of the long-run considerations of balancing the budget which must still be kept in mind. Plainly, the more taxes are cut and/or spending increased, the further away we will move from the path of a balanced budget. And as I have said time and again, the only way we are going to make any fundamental progress against inflation is for Washington to balance its books so that the Federal Reserve can keep the growth rate of money and credit down to a rate not exceeding the economy's ability to produce real goods and services.

All of this goes back to what I said in the June Report. What may appear to be bad economics (and even worse politics) for the shorter run, makes a good deal of sense, longer run. I think we should not only recognize that 1981's recovery will be slow, we should not do anything to offset this, so that we can continue working toward that elusive but necessary balanced budget, now a hopeful target for 1982. We have an opportunity to ensure a bright future for the longer run—provided we consider the long run in setting economic policy. H

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July, 1980

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< Actual				Projected >							
	1979		YEAR 1979		1980				YEAR 1980		1981	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2396.5	2456.9	**2368.8**	**11.3**	2520.8	2523.4	2531.4	2558.2	**2533.5**	**7.0**	2611.4	2666.8
GNP: $72	1433.3	1440.3	**1431.6**	**2.3**	1444.7	1410.8	1392.9	1383.4	**1408.0**	**−1.7**	1389.9	1400.7
% Change, Annual Rates	3.1	2.0	**2.3**		1.2	−9.1	−5.0	−2.7	**−1.7**		1.9	3.2
Consumption	1528.6	1580.4	**1509.8**	**11.8**	1629.5	1628.2	1648.1	1663.9	**1642.4**	**8.8**	1694.1	1722.0
Durables	213.4	216.2	**213.0**	**6.4**	220.2	197.0	198.2	198.3	**203.4**	**−4.5**	206.6	213.1
Non-Durables	604.7	630.7	**596.9**	**12.5**	652.0	654.4	657.5	674.0	**659.5**	**10.5**	688.4	691.7
Services	710.6	733.5	**699.9**	**12.9**	757.3	776.8	792.4	791.5	**779.5**	**11.4**	799.1	817.2
Investment	392.3	387.2	**387.2**	**10.1**	387.7	366.9	340.7	339.1	**358.6**	**−7.4**	354.8	374.5
Non-Residential	261.8	265.2	**254.9**	**15.3**	272.6	265.9	263.2	263.1	**266.2**	**4.4**	263.4	261.3
Producers Durable Equipment	166.7	165.0	**162.2**	**12.2**	169.4	163.2	163.6	164.1	**165.1**	**1.8**	165.0	167.6
Structures	95.0	100.2	**92.6**	**21.1**	103.3	102.7	99.6	98.9	**101.1**	**9.1**	98.4	93.7
Residential	116.0	116.4	**114.1**	**5.6**	110.4	89.3	88.8	91.4	**95.0**	**−16.8**	101.2	115.3
Inventory Changes	14.5	5.6	**18.1**		4.7	11.7	−11.3	−15.4	**−2.6**		−9.8	−2.1
Net Exports	−2.3	−11.9	**−4.6**		−13.6	1.3	0.6	2.9	**−2.2**		−3.1	−5.3
Government Purchases	477.8	501.2	**476.4**	**9.4**	517.2	527.0	542.1	552.3	**534.7**	**12.2**	565.5	575.5
Federal Defense	109.0	114.6	**108.3**	**9.3**	119.6	123.6	128.6	135.2	**126.8**	**17.1**	140.9	146.8
Federal Civilian	53.9	63.8	**58.4**	**9.0**	66.6	68.9	72.1	71.0	**69.7**	**19.3**	72.3	73.4
State & Local	314.9	322.8	**309.8**	**9.5**	331.0	334.5	341.4	346.1	**338.3**	**9.2**	352.3	355.3
Final Sales: $72	1426.2	1439.0	**1421.9**	**2.7**	1444.4	1408.5	1401.6	1392.5	**1411.8**	**−0.7**	1394.0	1401.9
% Change, Annual Rates	6.4	3.6	**2.7**		1.5	−9.6	−1.9	−2.6	**−0.7**		0.4	2.3
GNP Price Index (1972 = 100)	167.2	170.6	**165.5**	**8.9**	174.5	178.9	181.7	184.9	**180.0**	**8.8**	187.9	190.4
% Change, Annual Rates	8.5	8.3	**8.9**		9.5	10.4	6.6	7.2	**8.8**		6.6	5.4
PCE Deflator (1972 = 100)	165.1	169.0	**163.3**	**8.9**	174.0	178.2	181.6	184.9	**179.7**	**10.0**	188.5	191.3
% Change, Annual Rates	9.8	9.8	**8.9**		12.4	10.0	7.7	7.7	**10.0**		7.9	6.1
Consumer Price Index (1967 = 100)	220.8	228.0	**217.6**	**11.3**	237.1	244.8	249.4	253.2	**246.1**	**13.1**	257.2	261.4
% Change, Annual Rates	13.4	13.6	**11.3**		16.9	13.7	7.7	6.2	**13.1**		6.6	6.6
Total Personal Income	1946.6	2005.0	**1924.2**	**12.0**	2057.4	2078.3	2101.9	2141.6	**2094.8**	**8.9**	2168.2	2197.4
Disposable Personal Income	1640.0	1683.1	**1624.3**	**11.4**	1737.4	1754.0	1779.8	1812.1	**1770.8**	**9.0**	1850.5	1873.3
Savings Rate	4.3	3.5	**4.5**		3.7	4.7	5.1	6.0	**4.9**		6.3	5.8
Employment Rate	58.4	58.4	**58.3**		58.3	57.6	57.2	56.8	**57.5**		56.7	56.9
Unemployment Rate	5.8	5.9	**5.8**		6.1	7.5	7.9	8.6	**7.5**		8.9	8.7
Indus. Production (1967 = 100)	152.3	152.2	**152.1**	**4.1**	152.2	144.7	139.4	138.1	**143.6**	**−5.6**	139.8	142.7
Housing Starts (000)	1808.7	1593.3	**1721.9**	**−14.3**	1263.3	1044.7	1227.1	1302.5	**1209.4**	**−29.8**	1513.7	1698.8
Domestic Auto Sales (000)	8633.3	7500.0	**8375.0**	**−9.9**	7933.3	5504.0	5963.6	6309.3	**6427.6**	**−23.3**	6879.9	7115.8
Corporate Pre-Tax Profits	242.3	243.0	**236.6**	**14.9**	260.4	203.8	192.4	182.7	**209.8**	**−11.3**	173.0	186.6
− Taxes	94.0	96.1	**92.5**	**9.5**	102.4	80.1	75.6	71.8	**82.5**	**−10.9**	58.4	63.1
Net Profits	148.3	146.9	**144.1**	**18.6**	158.0	123.7	116.8	110.9	**127.4**	**−11.6**	114.6	123.5
− Dividend Payments	52.8	54.4	**52.8**	**11.9**	56.7	58.6	59.8	59.6	**58.7**	**11.2**	59.4	60.5
Undistributed Profits	95.5	92.5	**91.4**	**22.9**	101.3	65.1	57.0	51.3	**68.7**	**−24.5**	55.2	63.0
+ Depreciation	132.8	135.2	**131.0**	**9.3**	137.4	139.3	145.7	149.6	**143.0**	**9.2**	156.6	160.2
− Inventory Profits	44.0	46.5	**41.8**	**65.7**	63.2	27.8	30.8	30.5	**38.1**	**−8.8**	33.4	35.7
Net Cash Flow	184.3	181.2	**180.6**	**6.9**	175.5	176.6	171.9	170.4	**173.6**	**−3.7**	178.4	187.5

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Four Recommendations

Now that the nation's two major political parties have nominated their candidates for president, serious campaigning is about to get under way. While there are many issues that need to be discussed, the fact that the U.S. economy remains mired in recession at the moment, and is faced with serious challenges longer run, has prompted many observers to offer advice to both major candidates. Depending on one's perspective, this advice can either be conflicting, or, at the very least, politically unpalatable. However, it is clear that something needs to be done in order to get our economy back on track.

As readers of this Report are no doubt well aware, the ongoing recession is only part of our economic problems. The rate of inflation, while somewhat less than at its high point at the first quarter of this year, stubbornly refuses to go below the double-digit range. Energy supplies are plentiful at the moment, but our dependence on foreign oil remains a potential trouble spot that will flare up when the demand for energy picks up once again. Our industrial base has been seriously eroded because of a variety of developments, causing a loss of some export markets and an increase in imports.

I don't claim to have all the answers, but it seems to me that if policymakers were to adopt just four recommendations, the U.S. economy could return to the track of faster growth, less inflation and minimal dependence on foreign energy. I present them below, listed in the order I think they should be implemented, under current economic conditions.

Balance The Budget

In this summer of recession, many ideas have surfaced to cope with our twin problems of recession and inflation. Some of them are interesting, but inappropriate, considering the present state of the Federal government's budget. Specifically, I refer to those proposals that would involve cutting taxes. Given the projected increase in the tax burden for 1981 that I referred to in the July Report, it is very tempting to go along with those who say that taxes should be cut in order to get us out of recession. However, to reduce taxes without a corresponding cut in Federal spending would be to widen the deficit in the Federal government's budget at a time when it is already too big. This deficit indicates that, increases in the tax burden notwithstanding, the Federal government will still be imparting stimulus to the economy. Even more important is the fact that the deficit must be financed.

Any kind of tax cut — whether consumer-oriented, or business-oriented — will place additional strains on the financial markets when the budget is in deep deficit. No matter how fast these tax cuts may generate increased revenues, they can never do it fast enough to prevent the government from borrowing more money in the near term to make up for the sudden shortfall in revenues compared with expenditures. If the budget was in surplus and the economy was in recession, there would be no question in my mind that cutting taxes would be appropriate. This is because the few billion dollars increase in Federal financing requirements would not put pressures on the financial markets. But the Federal government this fiscal year has already had to raise $50 billion to cover its anticipated deficit of $60.9 billion — not to mention an additional $22 billion to finance the federally-sponsored off-budget agencies. And this does not include the $135 billion that must be raised just to "roll over" previously issued securities.

Even without a tax cut, the Federal government's financing needs are creating strains in the financial markets. The Federal Reserve has been attempting to keep the growth of money and credit to a rate which would slow inflation. This means that the Federal government's current financing needs may have already caused interest rates to stop falling and begin to rise. If money tightens further, liquidity in the private sector will diminish, hitting hard such sectors as homebuilding which are heavily dependent on the availability and moderate cost of credit.

Clearly, a tax cut unaccompanied by an equivalent cut in government spending, would only exacerbate the

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situation. Of course, the Federal Reserve could respond (as it has done many times in the past) to the greater financing requirements of the public sector by simply creating more money and credit. If the Fed were to do this, it seems to me, then all it would be doing is laying the basis for a new round of inflation sometime in 1981 or in 1982. This, too, would vitiate the effects of economic policy.

That is why my first recommendation is that we balance the budget. I don't say that the budget should be balanced this year or even next. But I do believe that we should not disturb the tax structure so as to push further into the future the prospects for a balanced budget. Of course, it would help if we could curb Federal spending. However, given international tensions as well as domestic political pressures, I don't deem the likelihood of curbing Federal spending very great. So to keep on the track toward a balanced budget, we must preserve tax revenues. And to do this, we must eschew a tax cut. Since none of the tax cut proposals now in the hopper are likely to take effect before the beginning of 1981 at the earliest and since most economic forecasts project that the economy will be in recovery by then, I don't see much danger to the recovery from not cutting taxes. Indeed, even its staunchest advocates want a tax cut in 1981 not as an anti-recession weapon, but rather as pro-recovery insurance. In my view, the only thing we will be insuring if we cut taxes at this point is an early revival of inflation.

Decontrol Energy

Next to recession, the question of our dependence on foreign oil is most vexing. I am aware that we have made some progress toward decontrol. Natural gas shipped interstate is no longer subject to the tight layer of price controls that it once was. And some types of oil produced in the United States are free to be sold at world market prices. However, a large proportion of oil produced domestically remains under some form of price control. What is more, the Federal government, through the Department of Energy, has taken it upon itself to tell the oil companies where to ship this oil — in other words what region should get how much oil and gasoline.

When there is an excess amount of petroleum such as is the case today, this interference with the marketplace does not cause many problems. However, it continues to distort the price and production mechanisms sub rosa, laying the groundwork for future distortions when demand and supply come into better balance. And, when demand outstrips supply as was the case last year, Federal government interference only makes things worse.

I believe that the government should step out of the energy picture immediately. Whatever prices remain under control should be immediately freed to rise to world prices, and the government should cease and desist the allocation of petroleum products as well. Now is the best time to do this, while energy supplies are in excess compared with demand. Chances are retail prices for petroleum products will rise hardly any, if at all under present circumstances. Yet, by returning to the principles of the free market, the Federal government will be helping to make sure that we don't undergo a repetition of the long gas lines and sudden price hikes characteristic of the springs of 1974 and 1979.

Even now, there are a record number of rigs in operation drilling for oil. And the American Petroleum Institute reports that oil production in the 48 contiguous states rose in July compared with last year, the first monthly gain in over three years. Who knows how much more oil and gas exists that has either yet to be found, or is known to exist but is still too expensive to bring up, given current prices? I say no one knows, least of all the Federal government. That is why I believe that the pricing mechanism should be the marketplace and not the dictates of Washington.

Needless to say, there are other energy sources that we can turn to besides petroleum. Some, like coal and nuclear power, are already in use, but are having their problems with various groups of people. Others like coal gasification and liquifaction, shale oil, solar energy and geothermal power are being researched, but are still too expensive to be commercially viable.

I don't want to overlook the demand side. Already, the U.S. has made a major adjustment to higher energy costs. Gasoline use so far in 1980 is down anywhere from eight to ten per cent compared with the same time last year — and in some months has been as low as it was in 1973. This is no small feat considering that there are 20 million more vehicles on the road today than there were then. Some say this adjustment has been made by people driving smaller cars, which get better gas mileage. Others say it reflects a reduced rate of driving. Whatever the case, it seems to me that the bottom line is the same: Our use of gasoline is declining and will continue to decline as our mix of automobiles becomes even more skewed toward smaller, fuel-efficient models.

There are two other benefits that would flow from decontrol. The first is that our tendency toward oil-induced inflation would be minimized for reasons implicit in my discussion above. The second, and no less important, is on the international side, in the area of financial flows. It is no secret that payments balances of many countries in the world have been distorted significantly by the need to pay for high-priced oil. Indeed, the U.S. would be running a massive surplus on its international trade were it not for oil. Not only is oil covering up what is clearly a strong competitive position for many U.S. industries thus unnecessarily

cheapening the dollar, it is also responsible for the concentration of greater and greater financial resources in the hands of fewer and fewer countries, placing the burden on the international banking system to recycle these funds.

Restructure Taxes

We must also reorient our tax policy away from consumption and toward investment. Since my first recommendation above was that taxes not be cut in order to preserve the flow of revenues thus enhancing prospects for balancing the budget, what I mean here obviously is that business and investor taxes should be reduced while taxes on consumption should be allowed to rise. I recognize that this would be considered political heresy in an "off" year, much less in an Election Year such as we have in 1980. But as I have said many times in the past, what might make bad politics short run could make good economics, longer run. And it is the longer run to which we must address ourselves — the sooner the better.

I don't think there is much dispute that our tax structure as it exists today tends to dissuade businessmen from making investments in new machinery and equipment. The inability of businessmen to take into account the effects of inflation as they depreciate their physical plant, machinery and vehicles has caused them to pay more in taxes to the government than they should have, and left over less for new investments as a result. The rise of the capital gains tax has discouraged venture capital, seriously cutting into research and development outlays — especially among smaller companies where much of the innovations tend to occur. The so-called "progressive" tax structure takes away more income from those with the highest propensities to save and gives it to those with the greatest propensities to consume. While socially a seemingly desirable program, this tax structure has had the effect of reducing the pool of capital which business could tap in order to finance new investments.

I think that next year, after the elections are over, the government ought to seriously consider changing the tax structure to remove the bias against savings and investment. Some of the well-discussed proposals such as the "10-5-3" accelerated-depreciation package, which would let firms write off investments in buildings in ten years, machinery in five years and vehicles in three years, should be passed without delay. In addition, the investment tax credit should be increased, the capital-gains tax should be reduced and the progressivity of the tax structure moderated. I would also like to see more interest from savings being made exempt from taxation. To pay for this, we are going to have to tax consumption. There are several methods under consideration, which are likely to surface in the tax debates of 1981. I haven't made up my mind which one is best, but it seems to me that the widely-discussed value-added tax (VAT) is as good as any. Like any sales tax, the VAT is a tax on consumption: You don't pay taxes on what you don't spend. And of course, what you don't spend, you save.

Reduce Regulations

Besides tax and energy policies, the government has impacted the economy through its role as a regulator. Since the mid-1960s, there has been a sharp rise in intervention by governments on all levels, resulting in what Adam Smith might have called, "the visible hand." Laws, administrative rules and guidelines are in constant flux, and are becoming increasingly complex and costly. It has been estimated that Federal rules alone add as much as one percentage point annually to the rate of inflation, while the cost of Federal regulation well exceeds $100 billion annually. What is more, these regulations have begun to interfere with the orderly functioning of our economic machine, making it less efficient, and ironically, moving us away from our basic goals of full employment and stable prices.

To be sure, we have always had to deal with government regulation. Each session of governments on all levels has tended to pass many new laws and only rarely struck old ones from the books. But in recent years, government intervention has been transformed from a relatively uncomplicated type of economic regulation, applied to a limited number of areas, to a staggeringly comprehensive and complex set of social engineering programs in an effort to affect directly the behavior of a whole society. Issues formerly settled in the marketplace have now become the province of the Congress, delegated via legislation for administration by the Executive departments and independent agencies, and often decided by the courts, whose judges are scarcely prepared for such additional economic duties. These decisions, rules and regulations are usually made without regard to market forces, individual incentives or the profit motive.

What is worse, many of these regulations conflict with one another. On the one hand, as *Business Week* magazine recently noted, the Environmental Protection Agency is pushing hard for stringent air pollution controls. On the other, the Energy Department is encouraging companies to switch from imported oil to dirtier coal. The National Highway Safety Administration has mandated weight-adding safety equipment for cars while the Transportation Department is insisting on lighter vehicles to conserve gasoline. These are just two of the many examples that can be cited as the fist of fiat prevails again and again over the invisible hand.

Old agencies and obsolete programs never die. They just keep spending and regulating. Today, at least 1200 of these alphabet-soup agencies have significant

regulatory power — an increase of close to one third in ten years. The Federal register, that compendium of agencies, rules and regulations, has put on considerable poundage, more than doubling in size since 1970. There is another aspect to this increase in government interference with the private economy — its unpredictable nature. Unlike economic, technological or other uncertainties indigenous to the private, free enterprise system, political uncertainties tend to be sudden, swift and unprecedented. It is entirely possible for a multi-million dollar factory to comply with all rules and regulations one day, and be declared in violation the next. Businessmen and investors can cope with the uncertainties of the marketplace; they always have. However, they cannot deal with the ever-changing "rules of the game" that arise from more and more government regulation.

In the final analysis, this subject may be the toughest of all to tackle. What I am talking about is not only declaring a moratorium on new rules and regulations, but actually cutting back some of the existing ones in order to unfetter the private free enterprise system. In effect, I am asking politicians to stop passing new laws and, instead, to legislate many bureaucrats out of a job for the greater good of the American people. Your guess is as good as mine as to when, if ever, this will come about, but at least the issue has been joined, and the burden of proof is now on the regulators to justify their continued existence. H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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SEPTEMBER 1980

Is The Cycle Telescoping?

To listen to some observers, the business cycle appears to have suddenly been telescoped in time. What used to take years to happen now occurs in a matter of calendar quarters. And what used to take several quarters to take place now occurs in a matter of months — if not weeks.

Looking back on the first nine months of this year, it is amazing how widely (and violently) sentiment over the course of business has swung this year. Projections by economists for a recession notwithstanding, most businessmen, consumers and investors believed in January that no recession was in sight. By May, these same folks were looking for the end of Western Civilization as we know it, in view of the steep plunge in economic activity then under way. Now in September, sentiment has apparently swung once again toward the side of optimism, in that a growing number of people believe that the recession has ended and that recovery is now under way.

But this is not all. Along with this change in attitudes toward the economy has come a revival of inflation expectations and a turnaround in interest rates. Both of these have come at a rather unusual time. In the case of inflation, it follows in the wake of the best performance by the consumer price index for any month in 13 years. In the case of interest rates, it ignores past history since, even after recessions have ended, interest rates in both the short- and the long-term markets have generally continued to decline.

If interest rates and the inflation rate do rise, I would guess that by the turn of the year sentiment will once again be bearish. Even now homebuilders fear that the recent runup in mortgage interest rates will undermine the incipient recovery in new-home starts. Obviously, higher interest rates could affect a wide variety of other activities — including business capital investment and consumer spending on durable goods. Meanwhile, an upturn in the rate of inflation and the expectation of inflation would require a greater number of dollars to complete transactions than the Federal Reserve is apparently intending to provide to the domestic economy thus slowing aggregate activity for lack of liquidity.

On the fiscal front, things would seem to argue for caution as well. As I have pointed out in the past, the tax burden on most people will rise significantly in 1981 — tax cuts notwithstanding. Combined with inflation, this would seem to militate against any early revival in purchasing power both for business and consumers.

The Fed's Contribution

To what do we owe these rapidly-changing views? I can think of several reasons. The first was the unprecedented use of credit controls by the Federal Reserve earlier this year. Admittedly necessary to dampen the inflation psychology that was rampant, the Fed's program was widely misinterpreted. Rather than cutting down on use of credit, many people stopped using credit entirely after the Fed's policy package was announced on March 14, even though that was not its intent. The result was an unprecedented paydown in consumer debt to the tune of $9.5 billion in four months. This much credit has never been paid off in so short a period of time. It had the well-documented effect of causing the economy to fall like a lead balloon in the second quarter, since consumer spending accounts for two thirds of the GNP. It was this decline in use of debt that helped pave the way for an increase in consumer spending. People began to borrow again, once the credit controls program was lifted at midyear, allowing some deferred spending to take place.

This improvement in consumer spending should be kept in its proper perspective. August's level of retail sales, at $79.5 billion, was no higher than levels first reached last January. And this is in current dollars, unadjusted for higher prices. In "real" terms sales remain at least five per cent below their January levels. For this to be a consumer spending boom, sales are going to have to continue to rise. Yet those people who believe that a recovery is underway also believe that inflation is flaring up again, and if this is

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the case, I don't see how sales can continue to rise since people's buying power remains low, as does their stock of savings. What is more, business inventories seem high, and if business begins a program of inventory liquidation, it would result in production cutbacks and employee layoffs, thus further hindering any sizable improvement in consumer spending.

Sticking with the Federal Reserve, another aspect of Fed policy which has contributed to the greater volatility in the economy, is its emphasis on the monetary aggregates and its greater willingness to let money-market interest rates fluctuate in a wider band. The emphasis on the monetary aggregates is a good one, however, financial market participants tend to overlook just how the Federal Reserve is monitoring these aggregates. It may be true that the Fed has monthly and quarterly targets for the growth rate of the various measures of the money supply. However, these are only "fine tuning" targets to help the Fed achieve its annual objectives laid out earlier this year. Thus, even though the money supply has jumped sharply in recent weeks, M-1A and M-1B are still growing within the Fed's target ranges, while M-2 is only a tad above the Fed's 1980 target range.

The volatility part comes in because the weekly money supply numbers tend to be erratic. And because of this, financial market participants either mark up or mark down interest rates anticipating both the money supply numbers and the Fed's likely reaction to them. Finally, even if the Fed were able to mete out money at a steady rate week in and week out, interest rates would fluctuate because the demand for money is never constant. Whatever the case, the financial markets have become extremely jumpy in the past year, and this nervousness has been communicated to the rest of the economy.

Everyone Is Trying To Forecast

A third reason is sort of an outgrowth of the second, and that is that too many people are paying too close attention to every economic statistic. One of the first things that students learn in Economics I is that nothing moves in a straight line. These days, the minute a statistic changes direction, it is assumed to represent a major change either for that statistic, or for the economy. Economists are not alone in overreacting to changes in numbers. Many others are getting into the act, such as elected officials, businessmen and journalists. Little wonder that volatility has become the order of the day!

Personally, I think that a lot of this volatility in the economy is more apparent than real. The financial markets may change direction from day to day, but the economy doesn't. Once a recession gets under way, it has to run its course—and in the present circumstance, that means that business still has to address the problem of excess inventories. Given current rates of inflation and interest rates, not to mention the low rate of savings and the high use of debt, it seems unlikely that consumer spending can continue to recover the way it has done in the past three months. That being the case, business will have to liquidate inventories, and in the process, cut back output and lay off workers. Plainly, such a development would put a further crimp into consumer spending, thus keeping the economy in recession. As the decline continues, the underlying rate of inflation should moderate while interest rates should resume their downward course. Both of these developments would set the stage for a true recovery to get under way—but not before the beginning of 1981. H

Slow Growth Threatens The Global Economy

Although the worst of the U.S. recession appears to be over, the worst may yet come overseas. A number of trends both here and abroad are discernible, which if allowed to develop, could well lead to considerable economic difficulties in the next 18 months. Economic well-being hinges on two important factors: trade and capital investment. Both of these are endangered by recent developments.

In the United States we are somewhere past the middle of a middling recession and—although we can see the light at the end of the tunnel—the recovery which is anticipated looks to be slow and painful. The effects of this recession have been mixed. The rate of inflation has declined from its high point earlier this year, but at a "base" rate of over ten per cent it has become deeply entrenched in our economic system.

On the other hand, exports of goods and services have been a bright spot. In spite of the huge increase in OPEC oil prices (over 130 per cent since the beginning of 1979) and high global inflation rates, the U.S. trade deficit this year will be close to last year's $29.5 billion. The current account is expected to be in deficit this year by about $1 to $2 billion, also close to the 1979 deficit. This comparative stability in the balance of payments has resulted from a sharp drop in imports as economic activity in the U.S. declined. Exports have held up due to the weak dollar and a higher level of growth in the economies of most of our trading partners so far this year.

Yet the growth prospects of the other industrial countries for the rest of this year and next are becoming increasingly clouded as the sharp rise in the cost of oil imports leads to low growth, anti-inflationary economic policies. With low growth policies at home, these countries will look to the export sector to sustain their economies. Yet with the U.S. recession lowering

our import demand — not to mention boosting competition for export markets — the burden that will be placed on the export sector will grow significantly. Those economies whose structure is skewed toward heavy dependence on exports will suffer particularly.

The International Monetary Fund (IMF) in its most recent annual report predicts that real growth in the industrial countries of the free world will probably not exceed one per cent each year in 1980 and 1981. In 1979 real growth in the industrial nations was about 3½ per cent. As a result of the oil price increases, the current account deficits of the industrial countries this year may total as much as $65 billion — a major part of the anticipated $110 billion OPEC surplus. For the first half of 1981 a further $25-$30 billion aggregate current account deficit for the industrial countries seems likely. Some major economies are expecting substantial current account deficits this year: West Germany, some $14 billion and Japan, close to $17 billion. In 1981 these deficits, though smaller, will still be large.

World Trade Is Slowing

The prospects of low growth or recession in 1980 and 1981 followed by sluggish recovery in the industrial nations has important global implications for trade. The industrial countries of the free world account for some 72 per cent of total free world trade. As these countries struggle with the ever-rising cost of oil imports and low growth, the best that the volume of world trade may be expected to rise would seem to be about three per cent this year and next after a 6.5 per cent rise in 1979. Trade volume growth in the last decade has averaged almost seven per cent per annum. Since exports must equal imports worldwide, reductions in the rate of growth of world trade have a direct and profound effect on those economies (particularly the non-oil producing developing nations) who look to exports to generate foreign exchange for necessary imports, particularly oil, and debt repayment.

Yet another effect of low growth and the rising costs of imports is as a threat to trade liberalization. On the one hand, trade liberalization is encouraged as a means of promoting economic growth, adjusting payments imbalances and providing the means for social and economic development. On the other hand, as unemployment rises, current account deficits grow and bankruptcies in major industries threaten, protectionist sentiment rises — witness, the pressure for protection of domestic automobile industries against Japanese imports in the U.S. and EEC as one example. At the same time we have before us clear evidence of the role of quotas, high tariffs and other trade barriers in extending and deepening the worldwide depression of the 1930s.

Most profoundly affected by a decelerating growth in trade will be the less-developed countries (LDCs), many of which are almost totally dependent on exports of one or a few basic commodities for the foreign exchange needed to finance development. They have been particularly hard hit by a rapid degeneration in their terms of trade. Not only have oil prices skyrocketed, but prices of other imports, particularly of capital goods, have also risen rapidly, in recent years. At the same time, the prices which the LDCs receive for their exports have not risen as much. On top of this, the LDCs are now faced with the prospects of increased competition in exporting to a world with slowing economic growth. This will lead to pressure to reduce their export prices, exacerbating their financial difficulties.

Long-term changes in world trade patterns illustrate some of the problems of the LDCs. In 1960 exports of non-fuel primary products totaled nearly 40 per cent of the value of world trade, manufactures accounted for 50 per cent and fuels for 10 per cent. By 1979, non-fuel primary exports had dropped to 20 per cent of the value of world trade, fuels were 20 per cent and manufactured goods were 60 per cent. This shift in trade patterns has left the LDCs, which are heavily dependent on the export of these primary products, with a diminishing share of the world export market and of world export earnings.

LDC Debt Is A Problem For The Banks . . .

In an attempt to overcome the obstacles to development which uneven inflationary growth in export prices has created and under pressure from growing populations seeking higher living standards, the LDCs have turned increasingly to financial institutions, particularly commercial banks, for funds. These loans have been devoted not only to financing specific development projects but more and more in recent years to financing balance of payments deficits — not to mention paying interest on previously-incurred debt. Since the oil price shock of late 1973, aggregate LDC current account deficits have increased by about $200 billion. It is probable that the LDCs will be seeking at least $40 to $50 billion in additional financing this year and perhaps an equal amount next year in order to help finance the expected aggregate LDC current account deficit of $60 billion. Some portion of their financing needs will be met through borrowing from such official international financing institutions as the IMF, the regional development banks and the World Bank. Another portion will be supplied through bilateral government-to-government borrowing, while another portion will be generated by drawing down international reserves. But a very large portion, if not the majority of the LDCs financing requirements, will be sought from the multinational commercial banks.

In recent years, particularly since 1974, commercial banks have assumed an ever-increasing role in financing LDC public debt. As the cost of financing oil and other imports has become ever-more onerous, official sources of funds have become inadequate and in

some cases their lending conditions have been deemed too burdensome. The commercial banking system has been able to meet the need of the LDCs, and of other borrowers as well, through the efficient mobilization and reallocation of financial resources worldwide. This process has successfully withstood the wrenching stress placed on it in one direction by the enormous flow of financial assets into the hands of the oil producers and the equal stress of redistributing those assets and other financial resources to the debtor countries.

But the economic events of the last six years have taken most of the stretch out of the system. The ability of the international monetary system and the commercial banks to accommodate these new demands has about reached its limits. There is a very real question about the capacity of the multinational banks to continue lending to some of the LDCs because of legal limitations on lending to single borrowers, prudent portfolio management, capital adequacy and judgment based upon careful analysis of potential economic and political risks.

The major banks in the principal industrial countries now have in excess of $160 billion in claims on the non-oil producing LDCs—over half of the LDCs' estimated public and private external debt. One year ago the figure was about $130 billion. As oil prices and other import costs escalate, the LDCs' annual borrowing requirements will rise as well. At the same time, the ability of the banks to service these requirements will likely diminish. It is not yet apparent what new institutions will absorb this new debt and at what cost. As the level of debt rises, risk increases; as the demand for funds rises, so does the competition for the funds available. Both risk and demand are components in determining interest rates. As interest rates rise, the cost of servicing the debt adds to the burden of the LDCs. An ever-increasing percentage of LDC borrowing now goes to service existing debt rather than into new development projects.

In several cases, individual LDCs are now at or near the limits of their ability to borrow. Although outright default is rare, debt rescheduling is becoming more and more common. The debt of the LDCs is unevenly distributed with a few larger countries accounting for the bulk of it. Twelve LDCs accounted for about 65 per cent of total LDC debt at the end of 1979. A few of the very large LDCs are having increasing difficulty in financing their debt in the international financial markets, and the rescheduling of their existing debt is a growing probability.

. . . And OPEC Surpluses Are Growing

So far, this discussion has centered on the demand for funds. On the supply side the ability of the international financial system, particularly the banks, to recycle the OPEC investable surplus is another problem. It is commonly conceded that this surplus, expected to be close to $110 billion this year, will continue to be very large in the foreseeable future. Next year it is forecast to be at least $90 billion. Since 1974, as the size of the annual surpluses have waxed and waned, the international banks have been the principal vehicle through which these funds have been recycled. Given the limited number of ways in which these huge financial flows can be placed, there is no reason to think that this will not continue to be the case.

However, it is the banks acting as intermediaries who assume the responsibility for the allocation and security of these deposits. In a world of declining real growth, growing debt by the poorer nations, as well as economic and political instability, good investment opportunities are growing scarcer. As a result a "two-tier" market may well develop in which interest rates and maturity periods more closely reflect the perceived risks in individual loans. Higher interest rates and shorter loan periods for the LDCs will result. Another effect may be that a larger proportion of the surplus may be invested in the government securities of the major industrial nations, helping to finance their current account deficits, or in other real or financial assets in these countries. This would have the effect of reducing the supply of funds of the LDCs, further aggravating their problems.

The next 18 months would seem to be a critical period. Either more time will be bought for longer-term solutions to these problems, or there will be major economic (and possibly political) unrest. An extended period of global low growth, the introduction of protectionism, beggar-thy-neighbor economic policies, sharp cuts in living standards with the disappointment of social and economic aspirations, debt default by one or more or the LDCs with consequences for the international financial system—any or a combination of these could introduce a period of economic chaos. On the other hand, timely recognition of the risks and prompt remedial action can lead to stability and a return to growth.

It would be simplistic to blame the problems discussed above solely on the continuing rise in oil prices. Narrowly nationalistic political and economic policies, long-term structural defects in national economies, wide discrepancies in inflation and growth rates, and increasing competition for limited markets and resources have played their role as well. As long as these factors continue to exist, stable economic growth will be a chimera. New ideas and institutions will be required to meet the challenge of the times.

—William L. K. Schwarz, Vice President

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

OCTOBER 1980

Economic Forecast for 1981

This is traditionally the time during which economists crank up their mathematical models, activate their computers or, simply, peer into their crystal balls in an effort to aid their employers, clients or whoever in planning for the year ahead. I have never known there to be an "easy time" to forecast, but, it seems to me, this time is more difficult than most. This is because there is not only the usual amount of uncertainty over where the economy is going—there is a great deal of confusion where we have been!

If one looks no further than some of the recent economic statistics, one might have reason to believe that the 1980 recession came to an end sometime last summer. Retail sales have been climbing since June, fueled by a recovery in two major industries—homebuilding and automobiles. Employment has climbed by 670,000 since June, while the unemployment rate has dropped by several tenths of one per cent. Personal incomes are up by $69 billion, while industrial production has climbed by 1.6 per cent since July. Needless to say, these rising monthly numbers were enough to push up the overall economy by an annual rate of one per cent in the third quarter, as measured by the change in the gross national product adjusted for inflation.

Leaving aside, for the moment, the question of whether or not these numbers accurately portrayed the state of the economy during the third quarter, there is still a question in my mind regarding the course of the economy because these rising statistics have been accompanied by two other statistics which have gone up: interest rates and the rate of inflation. It is most unusual for interest rates and the rate of inflation to pop up at this point in the cycle. If the recession is still on, rising interest rates and higher inflation rates will only worsen and prolong it. On the other hand, if recovery has, indeed, gotten under way, then the uptrend in interest rates and the rate of inflation are sure to weaken it—if not abort it altogether.

Business Remains Sluggish

I, for one, do not think the recession ended during the summer. I think the uptrend in many of the economic statistics of the third quarter represents nothing more than a rebound from the lows created artificially by the imposition of credit controls by the Federal Reserve. As has been well documented by now, many people misinterpreted the intent of the Fed's credit controls to mean that no credit was available whatsoever. Since four out of every ten dollars' worth of retail goods are purchased with the use of credit, and since consumer spending accounts for two thirds of the gross national product, it is easy to see how such a misunderstanding could lead to a sharp drop in economic activity during the second quarter. By the same token, it should have been expected that, once the controls were lifted, some deferred spending would have taken place, pushing up those statistics that deal with consumer spending, and, by extention, the overall economy.

Aside from the question of how to interpret the bounceback from the controls-induced low, there are concerns over the accuracy of some of these numbers. For example, the rise in several of the components of the retail sales figures for September appears to be at variance with similar numbers reported from other sources. In the case of September's preliminary estimate for retail sales, the largest contributor to the 1.6 per cent increase in the overall numbers was the six per cent rise in sales by automobile dealers. However, according to registrations reported by Ward's Automotive Reports, auto sales retreated in September, seasonally adjusted, to a 6.2 million unit annual rate from a 6.8 million unit clip in August. Furthermore, prices of new cars declined as manufacturers provided yearend discounts and rebates in order to help clear leftover 1980 models. Plainly, falling units and a lower average price do not, in my view, add up to a higher dollar figure the way the Commerce Department reported it initially.

Incidentally, the decision by the Bureau of Labor Statistics to include yearend discounts on leftover 1980 model cars in September's Producer Price Index created quite a stir. Granted, the Labor Depart-

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ment had been moving away from reliance on list prices and toward transactions prices in an effort to make the PPI a more accurate reflector of price trends—especially during periods of soft economic activity when discounts are widespread. However, it is interesting—if not suspicious—that the BLS chose September to include transactions prices on new cars. This is because these discounts are by and large a once-a-year phenomenon, thus, are impossible to seasonally adjust. What is more, when the 1981 model car prices are included in October's PPI, they will reflect a substantial increase, not only because Detroit raised prices on the new cars—but also because the increase will be percentaged against the lower discount base in September's Index.

Getting back to the retail sales statistics, another component that the Commerce Department said went up was sales by gasoline service stations. This, too, raises some questions, since the American Petroleum Institute said that gasoline consumption continued its downward trend in September while prices, as measured by both the Producer Price Index and the Consumer Price Index, declined. Of course, this drop in the dollar value of gasoline purchased could have been offset by a large gain in purchases of such automobile parts as tires, batteries or accessories. However, this seems to be unlikely, in view of the sharp cutback in driving that has been underway for some time in reaction to the recession and the high price of gasoline.

There are other questions that can be raised. For example, a good part of September's eight per cent increase in new orders for durable goods reflected a strong rise in transportation equipment orders, which in turn, were driven up by orders for defense equipment. Ordinarily, defense spending accounts for four per cent of factory hardgoods' orders. However, in September, defense spending contributed more than one-third to the increase. Since September marks the end of the Federal government's fiscal year, it could be that some last-minute ordering came from the Defense Department in order to use up funds left over from the fiscal year's allocation.

This same Federal force-feeding apparently affected September's housing starts numbers. In the face of a return of mortgage interest rates past the 14 per cent zone—a level that earlier this year caused both borrowers and lenders to back away and housing to collapse—housing starts recorded a surprising increase of nine per cent. Virtually all of this rise, however, reflected a bulge in Federally-subsidized units, prompted by special encouragement by several government agencies. Single-family home starts, which currently account for nearly three quarters of new-home construction, remained virtually unchanged in the month.

But let us, for the moment, overlook these inconsistencies and concentrate on what the current batch of numbers mean for the outlook. It would seem to me that these upticks are a far cry from the start of an economic recovery. Most of these numbers remain far below levels reached before the onset of recession. As was demonstrated during the 1973-75 recession, it takes more than a few months' uptrend to get the economy out of recession if the underpinnings are weak. As for the rise in the real gross national product, it might be unusual—but it is not unprecedented for the GNP to rise in the middle of a recession. It happened once, during the 1948-49 recession—and twice in the middle of the 1970 recession.

Where Will Strength Come From?

What I am saying is that for the third quarter's upturn to be considered the start of a new expansion, the economic statistics must continue to rise. Growth for the economy can come from one or more of four major sectors: consumers, domestic business, exports and government. Let us now examine each sector to determine which, if any, can be expected to impart strength to the economy.

Consumers have three basic sources of funds that can be used to purchase goods and services. They can rely on their current incomes, dip into savings (either by withdrawing funds from their banks, or by selling off financial assets) or by borrowing. Looking at the first, we find that, while incomes are growing by 10.3 per cent per annum, prices, as measured by the GNP version of the Consumer Price Index, the PCE deflator, are going up by 10.5 per cent, suggesting continued declines in buying power. Of course, people could dip into their savings. But the national income accounts numbers suggest that the savings rate, while up somewhat from the 30-year low recorded at the turn of the year, is nonetheless well below normal. Not only that, it is about half the rate that prevailed at this point in the last two recessions after which the consumer was able to increase his spending dramatically, thus helping to get the economy out of recession quickly.

Of course, savings are only one component of households' financial assets. In the second quarter net financial investment by households advanced at a record $603 billion annual rate after declining at a $78 billion clip in the first quarter. But the major factor accounting for this reversal was a sharp, $460 billion annual rate jump in the market value of corporate equities held by households, as the stock market rallied mightily in the wake of declining interest rates. However, since then, the stock market has fallen back. At the same time, the savings rate dipped in the third quarter as people stepped up their outlays faster than incomes expanded. This would

suggest that, at the margin, people do not have the wherewithal to fuel additional outlays.

People could turn to credit. The typical household today is in a much more comfortable credit position than it was at the turn of the year, when families had to set aside nearly 18½ per cent of their take-home pay just to service previously incurred debt. The drop in credit usage in the second quarter brought this ratio down to 17 per cent, although it has since gone up a tad. While below the record clip of earlier this year, 17 per cent-plus still represents an above-normal chunk of incomes that must be set aside to service debt.

If consumers are unable to power the economy ahead, perhaps business might. Looking at domestic business, we find that the steep decline in consumer spending left business with large amounts of unsold goods. The ratio of inventories to sales, discounting the disparate effects of inflation on the numerator and the denominator, has come down somewhat from its highs of the summer. However, it is still far above that which prevailed before the economy entered into recession, and it would seem to me that with interest rates as high as they are, businessmen would be reluctant to stock any more goods than they have to. Of course, business could spend more on capital goods and add strength to the economy this way. But this is unlikely to happen while the average operating rate remains in the mid 70s, and while growing chunks of investment funds have to go to comply with pollution control requirements, labor safety regulations or to become more energy-efficient. Not only that, uncertainty about government policies and erratic interest rates are acting to keep capital investment low and deprive the economy of whatever strength it might be able to derive from this source.

When they turn abroad, businessmen are confronted with problems, too. Balance of payments deficits notwithstanding, exports had been one of the true bright spots of the economy for the past couple of years. If the influence of oil is removed from the picture, either through volume or price, it can be seen that our trade picture has been in substantial surplus. Indeed, on the national income accounts basis our overall trade balance actually moved into substantial surplus in the third quarter, to the tune of an $18.6 billion annual rate. However, any further improvement is likely to be limited, since activity in the economies of our major trading partners has already begun to falter. Most economies of Western Europe are in or very near recession, as is our neighbor to the north, Canada. And even Japan's growth rate has slowed to a mere two per cent, which by her standards is tantamount to a recession. On top of this, the dollar has climbed in value against many currencies, compounding the difficulties that businessmen will have selling abroad.

That leaves the government sector. There is no question that government spending is rising rapidly. Defense spending, for one, is rising at the fastest rate since the Vietnam War buildup in the mid-1960s. As for nondefense outlays, they are rising rapidly, too, propelled largely by government spending on various types of transfer payments, most of which are indexed to the Consumer Price Index.

But I would question whether rising government spending should be counted as a plus or a minus. This is because this year, for the twelfth consecutive year and the twentieth of the past 21, the Federal government is running a deficit in its budget. Following fiscal year 1980's deficit of $59 billion, Washington is likely to run anywhere from $35 to $40 billion worth of red ink in fiscal year 1981. And that does not include a tax cut. If you factor one in of the dimensions discussed during the 1980 presidential campaign, you could easily come out with a deficit of $65 billion or more. Plainly, such deficits do not contribute to the economy's health. Indeed, I would say that they undermine it. Either the Federal Reserve must expand the supply of money and credit to help the government finance these deficits without drying up liquidity in the private sector, in which case inflation results, or, if the Federal Reserve holds fast, then interest rates jump up. As I pointed out at the outset, both rising interest rates and rising rates of inflation will either prolong a recession, or cause one.

Conclusions

Where I come out is on the side of those who feel that the economy is likely to turn down again during the fourth quarter, and that recovery will not get underway until 1981. The shape of this recovery as I have observed in the past, is unlikely to be very strong. Indeed, it could very well be marked by some months—or even a full calendar quarter—during which some numbers once again decline. This is because inflation will flare up again before 1981 gets too old, propelled by rising prices for food and fuel, along with increased labor costs. The increased dollar-oriented demands will run up against a Federal Reserve policy designed to keep the monetary aggregates under control. Needless to say, this will cause interest rates to rise sooner than they otherwise would in an economic recovery, thereby constraining the recovery by making it more difficult for businessmen and individuals to borrow. Purchasing power will also be drained by the increase in Social Security taxes next year, the so-called "windfall profits" tax on the oil companies and the effects of moving into higher tax brackets. H

October, 1980
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
in $ Billions

< ACTUAL PROJECTED >

	YEAR 1979		1980				YEAR 1980		1981				YEAR 1981	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2368.8**	**11.3**	2520.8	2521.3	2583.0	2615.8	**2560.2**	**8.1**	2673.9	2747.6	2830.5	2921.3	**2793.3**	**9.1**
GNP: $72	**1431.6**	**2.3**	1444.7	1408.6	1412.1	1404.9	**1417.6**	**−1.0**	1413.0	1421.4	1428.6	1434.1	**1424.3**	**0.5**
% Change, Annual Rates	**2.3**		1.2	−9.6	1.0	−2.0	**−1.0**		2.3	2.4	2.0	1.6	**0.5**	
Consumption	**1509.8**	**11.8**	1629.5	1626.6	1681.8	1701.5	**1659.6**	**9.9**	1739.0	1776.6	1833.1	1888.6	**1809.3**	**9.0**
Durables	**213.0**	**6.4**	220.2	195.7	209.3	210.9	**209.0**	**−1.9**	217.8	222.5	229.2	240.7	**227.5**	**8.9**
Non-Durables	**596.9**	**12.5**	652.0	654.1	666.4	675.8	**662.1**	**10.9**	689.6	707.7	731.3	752.1	**720.2**	**8.8**
Services	**699.9**	**12.9**	757.3	776.9	806.1	814.8	**788.8**	**12.7**	831.7	846.4	872.6	895.8	**861.6**	**9.2**
Investment	**387.2**	**10.1**	387.7	368.5	346.0	350.2	**363.1**	**−6.2**	367.0	390.7	404.7	418.7	**395.3**	**8.9**
Non-Residential	**254.9**	**15.3**	272.6	268.2	271.4	270.2	**270.6**	**6.2**	270.5	275.2	279.3	288.4	**278.4**	**2.9**
Producers Durable Equipment	**162.2**	**12.2**	169.4	164.5	169.0	169.8	**168.2**	**3.7**	169.1	171.4	171.9	177.6	**172.5**	**2.6**
Structures	**92.6**	**21.1**	103.3	103.7	102.4	100.4	**102.4**	**10.6**	101.4	103.8	107.4	110.8	**105.9**	**3.3**
Residential	**114.1**	**5.6**	110.4	88.9	92.5	97.5	**97.3**	**−14.7**	105.1	112.3	119.7	128.1	**116.3**	**19.5**
Inventory Changes	**18.1**		4.7	11.4	−17.9	−17.6	**−4.8**		−8.7	3.2	5.6	2.2	**0.6**	
Net Exports	**−4.6**		−13.6	−2.2	18.6	16.2	**4.8**		7.9	6.8	2.7	4.8	**5.6**	
Government Purchases	**476.4**	**9.4**	517.2	528.3	536.7	548.0	**532.5**	**11.8**	560.0	573.5	590.0	609.2	**583.2**	**9.5**
Federal Defense	**108.3**	**9.3**	119.6	124.1	129.1	139.0	**128.0**	**18.2**	142.7	147.3	151.5	158.9	**150.1**	**17.3**
Federal Civilian	**58.4**	**9.0**	66.6	69.2	65.5	68.3	**67.4**	**15.4**	70.1	70.5	71.8	73.6	**71.5**	**6.1**
State & Local	**309.8**	**9.5**	331.0	335.0	342.1	340.7	**337.2**	**8.9**	347.2	355.7	366.7	376.7	**361.6**	**7.2**
Final Sales: $72	**1421.9**	**2.7**	1444.4	1406.0	1418.9	1414.0	**1420.8**	**−0.1**	1417.5	1420.0	1426.0	1433.2	**1424.2**	**0.2**
% Change, Annual Rates	**2.7**		1.5	−10.2	3.7	−1.4	**−0.1**		1.0	0.7	1.7	2.0	**0.2**	
GNP Price Index (1972 = 100)	**165.5**	**8.9**	174.5	179.0	182.9	186.2	**180.6**	**9.2**	189.2	193.3	198.1	203.7	**196.1**	**8.6**
% Change, Annual Rates	**8.9**		9.5	10.7	9.1	7.3	**9.2**		6.7	8.9	10.4	11.7	**8.6**	
PCE Deflator (1972 = 100)	**163.3**	**8.9**	174.0	178.6	182.3	185.4	**180.1**	**10.3**	188.6	192.5	197.3	202.3	**195.2**	**8.4**
% Change, Annual Rates	**8.9**		12.4	11.0	8.5	7.0	**10.3**		7.1	8.4	10.4	10.5	**8.4**	
Consumer Price Index (1967 = 100)	**217.6**	**11.3**	237.1	244.8	249.1	252.9	**246.0**	**13.0**	257.8	265.2	273.8	284.0	**270.2**	**9.9**
% Change, Annual Rates	**11.3**		16.9	13.7	7.2	6.3	**13.0**		8.0	11.9	13.7	15.8	**9.9**	
Total Personal Income	**1924.2**	**12.0**	2057.4	2080.5	2141.1	2158.3	**2109.3**	**9.6**	2194.3	2255.9	2332.6	2410.8	**2298.4**	**9.0**
Disposable Personal Income	**1624.3**	**11.4**	1737.4	1755.9	1807.5	1821.5	**1780.6**	**9.6**	1849.2	1897.6	1960.6	2023.1	**1932.6**	**8.5**
Savings Rate	**4.5**		3.7	4.9	4.6	4.3	**4.4**		3.7	4.1	4.2	4.4	**4.1**	
Employment Rate	**58.3**		58.3	57.6	57.5	57.3	**57.7**		57.4	57.5	57.6	57.8	**57.5**	
Unemployment Rate	**5.8**		6.1	7.5	7.6	7.9	**7.3**		7.9	7.8	7.9	7.8	**7.9**	
Indus. Production (1967 = 100)	**152.5**	**4.4**	152.5	144.6	141.2	143.2	**145.4**	**−4.7**	144.7	146.6	147.1	148.1	**146.6**	**0.9**
Housing Starts (000)	**1721.9**	**−14.3**	1263.3	1053.0	1408.3	1354.5	**1269.8**	**−26.3**	1425.8	1442.7	1540.3	1607.8	**1504.2**	**18.5**
Domestic Auto Sales (000)	**8358.3**	**−10.1**	7933.3	5504.0	6466.7	6782.8	**6671.7**	**−20.2**	6856.1	7086.3	7171.2	7168.1	**7070.4**	**6.0**
Corporate Pre-Tax Profits	**236.6**	**14.9**	260.4	204.8	226.5	227.9	**229.9**	**−2.8**	234.5	236.6	240.2	248.2	**239.9**	**4.3**
− Taxes	**92.5**	**9.5**	102.4	77.6	86.9	87.5	**88.6**	**−4.2**	90.1	91.0	92.4	95.6	**92.3**	**4.1**
Net Profits	**144.1**	**18.6**	158.0	127.1	139.6	140.4	**141.3**	**−2.0**	144.4	145.6	147.8	152.7	**147.6**	**4.5**
− Dividend Payments	**52.7**	**11.8**	56.6	58.6	59.7	60.5	**58.9**	**11.6**	62.0	63.8	65.5	67.3	**64.6**	**9.8**
Undistributed Profits	**91.4**	**22.9**	101.3	68.5	79.9	79.9	**82.4**	**−9.8**	82.4	81.9	82.3	85.4	**83.0**	**0.7**
+ Depreciation	**131.0**	**9.3**	137.4	139.3	141.4	149.9	**142.0**	**8.4**	154.3	158.2	162.2	166.1	**160.2**	**12.8**
− Inventory Profits	**41.8**	**65.7**	63.2	27.4	36.3	27.4	**38.6**	**−7.6**	33.7	38.4	49.4	53.0	**43.6**	**13.1**
Net Cash Flow	**180.6**	**6.9**	175.5	180.4	185.0	202.4	**185.8**	**2.9**	203.0	201.6	195.0	198.5	**199.5**	**7.4**

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The Manufacturers Hanover
Economic Report

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An Essay on Keynesian Economics

The lopsided election results may be open to several interpretations, insofar as economic policy is concerned. Clearly, the first is simply that the voters did not care for the policies pursued by the previous Administration and are hoping for something better from the incoming President and the new Congress. Beyond this statement, however, it becomes less certain what the voters had in mind. Did they reject Keynesian economics in favor of monetarism? Did they discard liberal economic policies in favor of conservative economics? Are they looking for someone who follows the concept of "rational expectations"? Or maybe is it "supply side" economics that the electorate yearns for as opposed to "demand management"?

For that matter, are they looking for *any* economic policy? More than once in recent months the media has severely criticized the economics profession, claiming it is anywhere from just "muddling through" to being in a "mood of exhaustion and inadequacy." In some ways the media cannot be blamed for criticizing economists since one eminent member of the profession was moved to remark some time ago that "the rules of economics are not working in quite the way they used to."

I don't profess to be able to read the voters' minds beyond the simple statement noted at the opening of this Report. That is—to paraphrase elections past, many people probably believed that it was "time for a change." For one thing, I don't believe that most people are aware that there are different economic philosophies, and that some have been tried and found wanting while others are waiting in the wings to show their efficacy. For another, I don't think that it should boil down to a question of rejecting one type of philosophy in favor of another because we haven't given *any* economic theory a chance to work.

In our collective efforts to make the present as comfortable as possible, we have neglected the future. Unfortunately, the future has finally arrived, and we are paying for our sins of the past. In other words—our economic problems (including the growing questioning of economists' abilities as well) do not stem from the rules of economics changing. Rather, we are in the mess that we are in because of our unwillingness to abide by the rules of economics that already exist.

What's Right With Keynes...

Since not a few people are interpreting the election as a "mandate" to get rid of Keynesian economics, I thought it would be appropriate to discuss this month just what has gone wrong with Keynesian economics—and what hasn't. Taking the latter first, the one part of Keynesian economics that, in my view, we should hold on to is the use of a balanced budget. Contrary to popular belief, Keynes never directly attacked the classical notion that the Federal government's budget must be in balance. What he said was that during periods in which the level of employment declines, the government "willingly or unwillingly" should run a budget deficit to provide unemployment relief. This deficit, quite naturally, would be financed by borrowing money—what Keynes called "loan expenditures." He believed that such actions would increase people's ability (and willingness) to consume, thus extricating the economy from recession.

Those who have written about Keynes in an effort to interpret his writings have drawn the conclusion that budget deficits are quite acceptable during periods of economic slack. I would agree. Some authors believe that Keynes had a cavalier attitude toward budget deficits, pointing to the views of many of his disciples who assert that deficits do not matter. With this I would disagree. If Keynes did not place great emphasis on the implications of a budget deficit beyond that of stimulating the economy, it is simply because he believed that deficits should not be used as a main tool of economic policy, and when they were, they were to be used during periods of economic slack. It is Keynes's followers, and the politicians whom they educated, that are to blame for the "cavalier" attitude toward budget deficits that subsequently developed in the 1950s and 1960s.

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I recall one argument vividly: "Why worry about debt, when it is simply money that we owe to ourselves"? That was used as a justification by many so-called Keynesian economists to run persistent budget deficits even when the pace of economic activity was strong. This kind of thinking was brought to its apex when the notion of the "full employment balanced budget" was advanced. This view held that, while the economy might have been nominally expanding, it would never reach its full potential if the budget, calculated at hypothetical full employment, were in surplus. You can see where this led to a further departure from Keynes's basic notion of running deficits in bad times and surpluses in good times. Since "good times" were some phase of economic activity that could only be described theoretically, rather than a measure of what was actually happening, one could easily justify continued deficits in the budget.

To liberal economists, this seemed to assuage their concerns about high unemployment and unequal distribution of income. They could recommend policies that they earnestly believed would make the economy run even better than it might have been doing at the time. But it was the politicians to whom the notion of a "buy now, pay later" budget system proved most appealing, in that it provided an important assist in getting them elected. Politicians could now parade before the American people and promise all kinds of things without presenting a bill. There always seemed to be Federal money available to remedy whatever local ailment existed. And if it was not increased spending that they promised, it was lower taxes. Budget deficits soon became "acceptable" as a way of life. Little wonder that we got into the mess that we are in today!

The table to the right shows the sorry record of the postwar years as far as budget deficits and surpluses are concerned. As you can see, we have *not* followed Keynes's idea of running a deficit in bad times and a surplus in good times. Plainly, we have not had 12 recession years in a row, 20 out of the past 21 or 29 out of the past 37. Thus, before we are ready to cast off Keynesian economics altogether, we should observe that one aspect of his policies that might have worked—the idea of running budget deficits in bad times and surpluses in good times—was not allowed to because it was not adhered to.

What bothers me even more is that we have a new group of elected officials coming into Washington in January, committed to tossing out Keynesian economics in the name of fighting inflation—yet advocating what would amount to a substantial widening of the budget deficit. They want to cut taxes and increase defense spending before they can put into effect offsetting reductions in nondefense outlays.

FEDERAL BUDGET RECEIPTS AND OUTLAYS: FISCAL YEARS 1945-81

(Billions of dollars)

Fiscal year	Receipts	Outlays	Surplus or Deficit (–)
1945	45.2	92.7	–47.5
1946	39.3	55.2	–15.9
1947	38.4	34.5	3.9
1948	41.8	29.8	12.0
1949	39.4	38.8	.6
1950	39.5	42.6	–3.1
1951	51.6	45.5	6.1
1952	66.2	67.7	–1.5
1953	69.6	76.1	–6.5
1954	69.7	70.9	–1.2
1955	65.5	68.5	–3.0
1956	74.5	70.5	4.1
1957	80.0	76.7	3.2
1958	79.6	82.6	–2.9
1959	79.2	92.1	–12.9
1960	92.5	92.2	.3
1961	94.4	97.8	–3.4
1962	99.7	106.8	–7.1
1963	106.6	111.3	–4.8
1964	112.7	118.6	–5.9
1965	116.8	118.4	–1.6
1966	130.9	134.7	–3.8
1967	149.6	158.3	–8.7
1968	153.7	178.8	–25.2
1969	187.8	184.5	3.2
1970	193.7	196.6	–2.8
1971	188.4	211.4	–23.0
1972	208.6	232.0	–23.4
1973	232.2	247.1	–14.8
1974	264.9	269.6	–4.7
1975	281.0	326.2	–45.2
1976	300.0	366.4	–66.4
Transition Quarter	81.8	94.7	–13.0
1977	357.8	402.7	–45.0
1978	402.0	450.8	–48.8
1979	466.0	493.6	–27.7
1980 (preliminary)	520.0	579.0	–59.0
1981 (estimated)	605.0	632.4	–27.4

Sources: Department of the Treasury, Office of Management and Budget, House-Senate Conference Committee

This simply will not work. Its near-term impact on the Federal government's financing needs will be devastating, since any policy that calls for more spending and less taxes—regardless of what their classroom results might be—will in the real world widen an already swollen budget deficit. This will, in

turn, cause one or more of several possible adverse events to occur.

If the Federal Reserve continues to adhere to its present course of trying to slow the growth of the money supply to noninflationary proportions, then Washington's increased financing needs will have to be met by funds drawn from the private sector. This would imply not only less liquidity for business and consumers initially, but also higher interest rates as well. Higher interest rates, of course, make it less attractive—if not outright difficult—for business and consumers to spend.

Of course, the Federal Reserve could always "give in" and expand the supply of money and credit to meet Washington's increased financing requirements while accommodating everyone else. In this event, interest rates might stay stable for a while (and they might not, at that, since the financial markets are so sophisticated these days that they would catch immediately the extra injection of money into the system and begin to anticipate its inflationary consequences), but at the expense of worsened inflation later on. A higher rate of inflation drains purchasing power, thereby constricting consumer spending, while the higher interest rates that would eventually result will further depress economic activity by discouraging both consumer and business spending.

...What's Wrong...

Without question, there are aspects of Keynesian economics that are no longer applicable in today's world. Keynes did not believe in the automatic adjustment process that was central to classical or orthodox economic theory. At the heart of his General Theory was the proposition that a modern economy was unstable. He labeled as outstanding faults of the modern economy what he called the failure to provide full employment and an equitable distribution of wealth and income. The maintenance of high demand, therefore, became the central object of his economic policy. This entailed two things: managing the economy by government and managing by manipulating demand.

Looking at the world as it existed when Keynes matured and began studying and writing about economics, it is easy to see how he came to the conclusion of an inherently unstable economy. There were many booms and busts in the United States in its formative industrial years during the late nineteenth and early twentieth centuries. And if these cycles weren't enough, the Great Depression, during which his General Theory was written, probably provided sufficient evidence to Keynes that the economy needed some guidance from government.

However, we have learned a lot about economic theories and policies during the past half century. Those deficiencies in the system that produced booms and busts such as the absence of a central bank, reliance on a gold standard whose liquidity-creating abilities were not consonant with the economy's needs and, in general, a lack of understanding of when to run budget surpluses and when not to, have been largely remedied. The creation of the Federal Reserve, along with the end of the gold standard, and the development of such automatic stabilizers as unemployment insurance, Social Security and welfare sharply reduced the economy's tendency toward instability.

As it has been translated into specific policy, the one aspect of Keynesian economics that we have followed over the years, demand management, is one that should be put aside at this time. Demand management economics might have been appropriate for an era when the economy was performing well below par and needed the stimulus of government to expand consumption. That is to say, the Great Depression admittedly was a result of insufficient demand, thus it was right for the government to stimulate it. However, today's problem is not a lack of demand, but rather, insufficient supplies of goods—and more important, new productive machinery.

The Keynesian notion that supply increases will follow demand increases no longer holds true in a period of high inflation and high interest rates, both of which represent tremendous disincentives for business to invest. What is needed is a "new" economic policy that stresses supply instead of demand. Ironically, this "new" economics is not new but rather, is very old—as old as Adam Smith himself. This is because its focus is on economic growth through the encouragement of investment and production, and it sees such growth arising from a free response to the economic incentives of a free market. What is more, it believes that only the private sector can bring us sustained growth, thus there is a need to reduce the role of the public sector.

...And What Should Be Done

Therefore, before we pin the pro- or anti-Keynes labels on ourselves,—or, for that matter, before we discard Keynes altogether—we should remember that one aspect of Keynesian economics that has *not* been used (budget surpluses in good times; deficits in bad times) is still relevant, while another of his theories that *has* been followed (government interference in the economy through the vehicle of demand management) is no longer appropriate. In other words, the rules of economics still work—provided that we know what they are and follow them. ■

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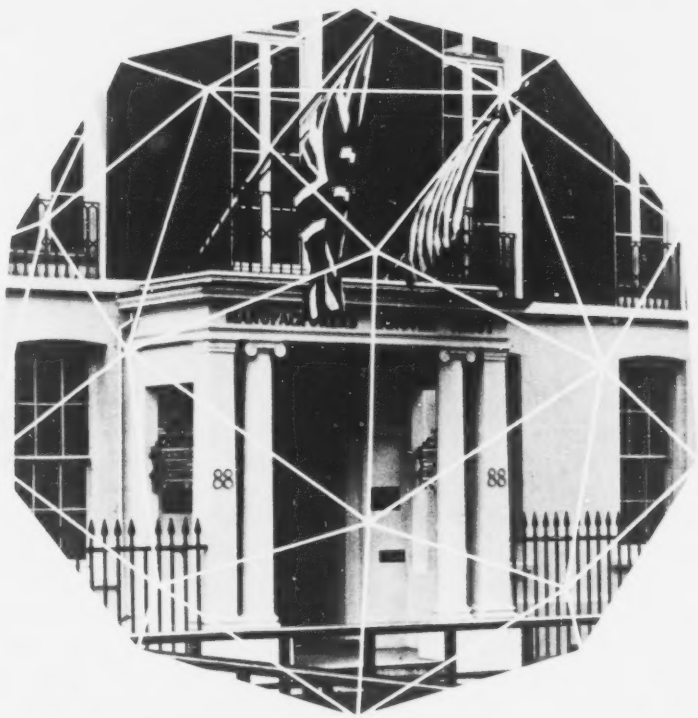

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

DECEMBER 1980

What Went Wrong?

As 1980 drew to a close, the U.S. economy found itself in the throes of its second credit crunch in twelve months—an unprecedented development in modern times. The yield curve turned steeply negative, disintermediation once again struck the nation's thrift institutions, many firms stepped up their demands for short-term credit, while at the same time a number of others found themselves unable to borrow because of steeply rising money costs.

Clearly, this development has significant implications for the 1981 business outlook. As 1980's first credit crunch demonstrated, there never has been a time in modern economic history when a credit crunch has developed and the economy has not gone into recession. Coming so soon after 1980's earlier slump, this downturn is striking before many individuals and businesses have had an opportunity to restore their balance sheets to a better state of health.

I do not intend to dwell on the business outlook in this issue. That will be taken up in more detail next month, following the release of the fourth quarter's data on the gross national product. What I would like to discuss this month is why such a credit squeeze is occurring. It certainly can not be the goal of monetary policy to produce repeated liquidity squeezes—especially as close together as the current one is to its predecessor. To say that interest rates are high because inflation expectations are high misses the point, since it should be the goal of monetary policy to reduce inflation pressures in order to promote a healthier economy. Of course, I recognize that when the government is running budget deficits of the size and frequency recorded in recent years, it becomes extremely difficult for monetary policy to avoid creating periodic bouts of high interest rates, high inflation expectations or both. Still, as my November Economic Report observed, budget deficits are nothing new to the U.S. economy. Credit squeezes, however, are: The first postwar credit squeeze didn't begin until 1966, and since then we have had four more, including the current one.

One reason why I think that interest rates have reached the heights that they have has to do with changes in government policy. It used to be that tight money impacted new-home construction fairly quickly, thus slowing the economy because housing is the nation's single largest industry with many others dependent on it. But the booms and busts that occurred in housing after World War II led to pressures to modify these effects, since they were producing a shortage of dwellings relative to potential demand, pricing a growing number of families out of the market.

As a consequence, Federal regulations regarding interest rates that thrift institutions could pay were changed. To the extent that the thrifts (which provide the bulk of the funds for residential mortgages) have been able to pay money market interest rates to attract deposits, they have retained an ability to lend for new-home construction and purchasing that they did not have before. Thus a given level of interest rates (nominal or real, for that matter) does not have the effect on the economy that it used to because of the "sheltering" of the housing market. Not surprisingly, interest rates have had to go higher, before affecting new-home construction—producing crunch conditions elsewhere.

The Role Of The Discount Rate

But this is only one part of the problem. I believe that there are some flaws in the way the Federal Reserve conducts monetary policy. Perhaps the most serious is the Federal Reserve's policy of establishing a fixed discount rate. As many of you undoubtedly know, the rate that the Federal Reserve charges member banks when they come to its discount window to borrow is basically fixed. That is—it does not fluctuate as do money market rates, but rather, remains at a given level for a considerable period of time. We learned in school that the Fed uses a change in the discount rate to achieve maximum publicity whenever it tightens or loosens monetary policy. In addition, the fact that some banks do go to the discount window to borrow offers the Fed an opportunity to "police" their lending activities. The Fed also views the discount window as a sort of

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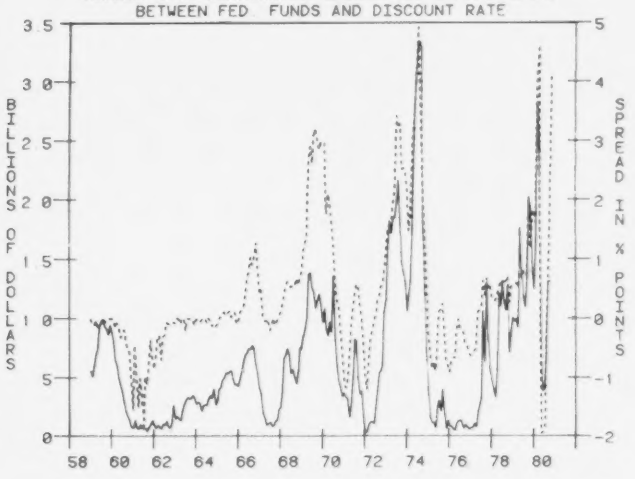
safety valve, allowing some of the pressures that might develop in the financial system during periods of extremely tight money to be vented.

CHART I
MEMBER BANK BORROWINGS (LINE) VS SPREAD (DOT)
BETWEEN FED FUNDS AND DISCOUNT RATE



I think what the Federal Reserve's fixed discount rate is doing is causing changes in member bank borrowing that the Fed can not control. As you can see from Chart I, there is a pretty good relationship between the trend in member bank borrowings from the Federal Reserve and the difference between the Federal funds rate and the Fed's discount rate. When this spread is large, member bank borrowings tend to be large; vice versa when the spread is low. It is clear that one of the main reasons why banks borrow at the discount window is that it is cheaper than borrowing from other banks at money market rates. Ironically, the tighter the Federal Reserve thinks monetary policy is getting (when it pushes up money market rates), the easier policy may actually be, since the greater are member bank borrowings.

It might be interesting to note that the Reichsbank, in post-World War I Germany, also had a policy of pegging the discount rate at a level far below money market rates. At one point during that country's bout with hyperinflation, the discount rate was 90 per cent when the market rate of interest on bank loans was more than 7,300 per cent per year. As the Federal Reserve Bank of Richmond recently observed, "This huge interest differential made it extremely profitable for banks to rediscount bills with the Reichsbank and then to loan out the proceeds, thereby producing additional inflationary expansions of the money supply and further upward pressure on interest rates."

If the discount rate were allowed to float rather than be fixed, things might be different. The Fed could have the discount rate float at a constant level relative to the Federal funds rate—perhaps some 50 basis points higher. Were this to happen, member bank borrowing would become far more predictable since the margin between the cost of funds at the discount window and the return on these funds would be constant. It would follow that the Fed's ability to control the money supply would be aided.

Interest Rate Concerns

Another problem with operating procedures is that the Federal Reserve has continued to look at interest rates—even under the new regime begun over a year ago of concentrating on control of the monetary aggregates. Economists have argued for the longest time that attempting to manage the monetary system by jiggling short-term interest rates was self-defeating, so we were glad to note the Fed's announcement of October 6, 1979 that it was going to move away from these interest rate-oriented operating procedures.

In actual fact, however, the Fed still pays close attention to interest rates. Quoting from a recent statement by Federal Reserve Chairman Paul Volcker: "We have...emphasized the limitations of using interest rates as a reliable indicator of the thrust of monetary policy. Nonetheless, we had to recognize that, even against the backdrop of a declining money stock, the already precipitous decline in interest rates might be misread as a fundamental reversal of policy—a lessening of our resolve to fight inflation." Further proof that the Fed is still overly concerned about interest rates and continues to use them relatively frequently as a guide to determining whether it should add or drain reserves from the banking network can be seen from a glance at the Board's operating instructions to the money desk of the Federal Reserve Bank of New York. They continue to contain target ranges for the key Federal funds rate—the only difference now is that the range is much broader than it used to be.

Underlying the use of a Fed funds target as the principal instrument of monetary policy execution is the notion that at some level the cost of borrowing money will inhibit borrowing, and at the same time, encourage the substitution of short-term interest-earning investments for cash. But, as can be seen from the current surge of business loan demand in the face of record-high interest rates, the cost of credit alone has little immediate influence on its demands. And if the demand for credit is strong and credit is available, then the Fed's policy of slowing the money and credit aggregates will not be successful.

From here, it would seem that credit availability, rather than credit cost, should be the objective of Fed policy. This can be achieved by a monetary policy that regulates what might be called the bottom line: i.e. the supply of bank reserves. The target statistic might be the monetary base, which could serve as a rough proxy for bank reserve availability. When the Fed begins to focus exclusively on the monetary aggregates and allows interest rates to be

determined by supply and demand in the market, then the Fed will have better control over monetary policy.

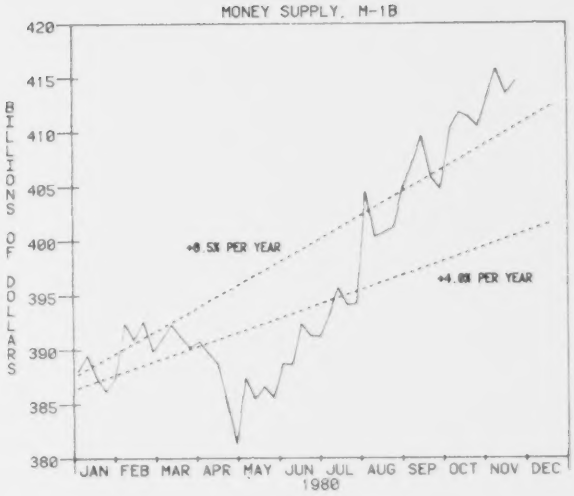
You will notice I did not say "control over the money supply." This may happen in time—but only after there is general agreement on just what is money. The definition of money keeps changing because of changes in regulations and technology and because of the innovativeness of the private sector. In an effort to capture the real-world byproducts of these developments, the Fed redefined money earlier this year. Thinking it could separate transactions from savings-type accounts, the Fed changed M-1 into M-1A (currency plus demand deposits) and M-1B (M-1A plus other checkables at banks and thrift institutions). Definitions for the other Ms were changed as well, and an all-encompassing L (for total liquidity) was introduced. Unfortunately, these definitions were nothing more than an admission of definitional shortcomings of the past and an attempt to catch up with developments that probably changed by the time these new concepts were introduced. Needless to say, the development of nationwide NOW accounts beginning January 1, along with the gradual elimination of interest ceilings on time deposits—not to mention continued innovativeness in the private sector—will continue to blur definitions of money.

Too Much Publicity

One additional cause for instability in the marketplace stems from the publicity surrounding the Fed's actions. To be sure, the Fed does not release the minutes of its policy decisions taken by the FOMC for at least one month. However, release of weekly statistics on the money supply, juxtaposed with monthly, quarterly and annual target ranges, has caused people to pay an undue amount of attention to these weekly data, which are, by and large, statistically unsound. Any weekly number tends to be mostly influenced by random events and contains a lot of statistical noise, and the money supply is no exception. Yet, because the Fed has announced annual targets, it is tempting for the markets to plot the weekly levels of the money supply and compare it with the Fed's target range.

The Fed announced earlier this year that it would like the money supply M-1B to grow at a compound rate of growth between four per cent and 6½ per cent from fourth-quarter 1979 to fourth-quarter 1980. Chart II depicts the target band described by these growth paths. Early in 1980 the money supply was growing within its assigned target range, but then it fell far below it as the economy nose-dived in the second quarter. It was not the cost of money that caused the economy to decline. Rather, it was its availability (or people's perception of its availability, since the Federal Reserve imposed credit controls, which were widely misunderstood). People came to believe that credit was not available, so they cut

CHART II
MONEY SUPPLY, M-1B



back their purchasing of big-ticket items, causing the economy to drop in the second quarter by a record annual rate of 9.6 per cent.

Once the Fed realized what was happening and lifted these controls, activity bounced back and with it the money supply. By July, the money supply was back in its target band—only to jump above it in September. The fact that the money supply remained above its growth target through yearend caused the markets to anticipate that the Fed will tighten further in order to drain reserves from the banking system and slow money's growth. These efforts to anticipate the Fed's operating tactics contributed to monetary instability, producing the latest credit squeeze.

Recommendations

As it seeks to regain control over the monetary aggregates, the Fed might want to consider making some changes in its operating procedures. Plainly, the Fed should institute a floating discount rate, thus removing what I would consider a major leak in the system. In addition, the Fed should pay less attention to money market interest rates—if it bothers with them at all. I don't think that the Fed should issue weekly money supply data, but if it must, it should provide better information on just what exactly money is and how its various holders and users view it. Certainly, the Fed should not release its interim (monthly and quarterly) "fine-tuning" targets, since these are merely guidelines to help the Fed make mid-course corrections in order to achieve its annual goals and are not inviolate in any given week or month, so long as they are achieved.

Most of all, I think the Fed should turn down the glare of the spotlight and put a little mystery back into its activities. Not only would this cut down on Fed-watching and the markets' tendencies to jump to conclusions—it might make monetary policy a little more interesting and the economy a little less unstable. H

Season's Greetings

...and a HAPPY NEW YEAR to all!

1981

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JANUARY 1981

Quarterly Business Conditions Analysis

I do not consider myself a contrarian. That is—I do not deliberately take a view opposite to everyone else just to be different. However, when it comes to economic forecasting—especially in recent years—a little bit of contrariness does not seem to hurt. Indeed, if one were to have forecasted the opposite of the general view on the economy and the financial markets during 1980, one's accuracy might have been significantly enhanced.

It is with this in mind that I view the consensus forecast for 1981 a bit suspiciously. The general feeling is that, after a slow start in the first half, the economy will pick up speed in the second. The rate of inflation will gradually decelerate under this scenario, although remaining uncomfortably high by yearend. Interest rates should fall somewhat during the year, but like the rate of inflation, also remain uncomfortably high. In other words—the consensus view for 1981 represents a playing out of the business cycle which began a year or so ago. Quite naturally, this view assumes that no new unusual external shocks will hit the economy and that the new Administration will be able to achieve some (but not all) of its economic objectives.

Such a scenario does not sound unreasonable to me. As a matter of fact, it is the one that I depict in the gross national product forecast table located elsewhere in this Report. For this forecast to stand a chance of coming true, however, several assumptions have to be made. The first is that the new Administration will modify somewhat its fiscal policy stance projected during the election campaign. That is—it will delay cutting personal taxes, cutting only business taxes to spur investment. Also, it will not boost defense spending much beyond what has already been projected. This would leave us with a budget deficit in the current fiscal year of somewhere in the $55-60 billion zone, and one in fiscal year 1982 half that or less.

On the monetary side, the Federal Reserve is assumed to continue to try to achieve its long-standing objectives of promoting relatively slow growth in the money and credit aggregates without precipitating either a credit squeeze or generating a new round of inflation and the expectation of inflation. The various definitions of the money supply are assumed to grow within their announced target ranges, and not gyrate wildly as was the case in 1980. Externally, better luck is assumed regarding the weather, food prices and the price of oil than was the case in 1980. This projection also assumes no major strikes in the United States and no significant change in the value of the dollar against the currencies of our major trading partners. In a word, it is a rather sanguine view of the outlook which looks for a much calmer economic and financial scene both in the U.S. and worldwide this year than was the case in chaotic 1980.

Maybe it's because I am so shell-shocked from the unusual events of 1980, but I just don't think things are going to fall into place so neatly. I think Murphy's Law ("If something can go wrong it will") is still alive and well. Thus, I am mindful of the many external shocks that could hit the economy this year, throwing it onto one of two alternate paths: deep recession (with a rapid slowing of inflation and sharp declines in interest rates) or no recession at all (with inflation and interest rates taking off for the stratosphere before very long). Let me take these two alternative scenarios one at a time and develop the line of reasoning behind each.

The Case For A Deep Recession . . .

It is very possible that we may be on the brink of a rather sizable recession. To be sure, I don't mean one as sharp as the one that occurred during second-quarter 1980. Rather, I mean one more typical in nature, with the gross national product adjusted for inflation dropping at annual rates of three to four per cent per quarter for two or three quarters. Even by recent standards, this magnitude of decline in economic activity would have some slowing effect on the rate of inflation, thus bringing down interest rates as well.

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The tendencies for the economy to lapse into such a recession are certainly present. For one thing, buying power of the typical family has been cut significantly by a combination of events. The first is that prices of oil have gone up in the past few months. Since October, the average price of oil we import has gone from $33.83 per barrel to $36.31 per barrel—an increase of 7.3 per cent. In addition, the cold winter in many parts of the country has caused households to consume much more in the way of oil and other fuels as well, thereby further increasing their fuel costs and leaving them less money to spend for everything else. The weather has also affected food supplies and prices. While we have yet to feel the full effects of last year's drought in the Farm Belt, we now have the effects of a freeze in the Southeast to contend with as well. This undoubtedly will boost food prices even further, again draining buying power. Finally, Social Security taxes went up 5.6 per cent on January 1, reducing take-home pay commensurately.

Aside from these factors, there are other indications that the economy may be poised for a renewed downturn. For one thing, the important automobile and homebuilding industries are sluggish. Housing starts fell 25 per cent in 1980 compared with 1979, while sales of domestically-produced autos dropped 21 per cent. With various attitude surveys showing consumer buying plans down, it is unlikely that these industries in particular, or consumer durables in general, will show any improvement any time soon, and past experience indicates that it is very difficult for the economy to mount a recovery if this sector is in the doldrums.

The business side does not look any better, either. The latest survey of purchasing agents shows the biggest shift in new orders in any single month since World War II, causing purchasing executives to turn pessimistic. Not surprisingly, machine tool ordering is down, while the Government's latest survey of capital investment plans shows only a slight increase in expenditures on new plants and equipment after factoring out inflation. Such a development is not surprising, in view of the fact that "real" interest rates (nominal interest rates minus the rate of inflation) are at a record high. This means that the real cost of money is higher than the real rate of return likely to be garnered from putting these borrowed funds to use.

These arguments alone do not guarantee that the economy will lapse into recession. It might take one or two unusual shocks for this to happen. While not predicting any of these, several come to mind which could well trigger such a downturn. The first deals with monetary policy. Knowingly or unknowingly, the Federal Reserve could overstay its policy of monetary restraint. That is—the Fed could keep draining reserves from the banking system in order to prevent interest rates from falling in response to the slowing economy so as to avoid a repetition of the roller coaster swings in interest rates in 1980. Needless to say, this might starve the economy for liquidity, causing spending by both businessmen and consumers to be cut back, thereby producing recession. As part of this, one or two major business bankruptcies might well shock people into pulling in their horns because of new uncertainties. There could always be a development in the Middle East that would result in a significant cutback in oil supplies to the industrialized world, which would have a negative impact on the U.S. economy for obvious reasons.

. . . And For None At All

On the other hand, it is entirely possible that the economy will skirt recession altogether, and because of this, the rate of inflation might accelerate, pulling up interest rates with it. For just as there are some statistics that depict weakness in the economy, there are others that suggest just the opposite. What is more, these latter statistics seem to be more in concert with the recent tendencies of the U.S. economy to turn out to be stronger than anticipated. For one thing, the leading economic indicators rose for six months in a row toward the end of 1980. The Conference Board's index of help-wanted advertising jumped 17 percentage points in three months. Not surprisingly, first-time claims for unemployment insurance at the end of 1980 were down to their second lowest weekly level in ten months. And while retail sales dipped a bit in December, they had climbed during the previous five months—enough to help most businessmen get bulging inventories back into better shape.

There are other factors as well. While autos and housing have indeed tumbled, they are probably not as important to the economy as they used to be. For example, ten years ago expenditures on motor vehicles and parts amounted to nearly seven per cent of total consumer spending. By the end of last year, that percentage had declined to about 4¾ per cent. Consumer spending on furniture and household equipment similarly fell from six per cent of total personal consumption expenditures ten years ago to 5.3 per cent today, while residential fixed investment has dropped from 31 per cent of total gross private domestic investment ten years ago to 27 per cent currently.

There are other factors that should make us think twice before anticipating weakness in the coming months. For example, there may be more purchasing power out there than economists generally think. This was demonstrated by the Government's recent revision of the gross national product statistics which, among other things, elevated the savings rate by 0.7 percentage point, or $9.2 billion, for the past

ten years. Then there is the so-called "underground" economy, consisting of funds earned but not declared, thus not in the personal income statistics. Like the black hole in space, the underground economy can not be seen, but its presence is no doubt being felt in the form of this latent economic strength that economists keep underestimating.

In addition to this, I think I have found another source of buying power that until now may have eluded economists. It seems to me that any family that earns more than it spends is bound to come out ahead even if prices go up about the same as its income. This is because the same percentage increase is applied to the larger income base, yielding a bigger gain in dollars than the rise in the cost of goods bought. And, progressive tax brackets notwithstanding, enough families are in this position, since there are savings for the consumer sector as a whole. Furthermore, when you consider that even the best measure of inflation does not reflect the market basket of goods and services that the typical family purchases, it is entirely possible that while economists bemoan the impact of inflation on people's buying power, in actual dollars, there is more money available to be spent than meets the eye.

The monetary statistics should also be looked at very carefully when determining how much liquidity is in the economy to finance continued growth. The shift to nationwide negotiable order of withdrawal (NOW) accounts on January 1 means that more money will be available for immediate spending than might have been the case previously, when much of these funds were "locked up" in savings accounts, thus less likely to be touched. Another addition to spending power will undoubtedly come from fiscal policy. Projections by the Carter and Reagan Administrations notwithstanding, the facts are that the budget deficit so far in the current fiscal year is running at an annual rate of over $65 billion—without any tax cut.

Of course, all this potential buying power will not keep the economy out of recession unless it is utilized. One factor that I can think of which might get people to increase their rate of spending is a reappearance of inflation psychology. I don't mean the kind that existed a year ago, which drove prices of precious metals to the moon. Rather, I mean the kind that shows up in everyday purchases, as people remember the attitudes they first developed in the spring of 1978: Prices are not likely to stop rising regardless of who is in power. Personally, I think many people have already come to this conclusion, but I would look for this to intensify if several other developments were to appear on the national scene. If oil prices were to take off once again where the price of oil at the wellhead were to reach $50 a barrel in short order, if the 12-month rise in food prices, now around ten per cent, were to escalate to, say, 15 per cent, if major contract settlements called for wage increases to reach 12 per cent from last year's 9.5 per cent, if a war involving the U.S. should break out any place or if personal taxes were to be cut retroactive to January 1, I would expect inflation psychology to heat up, producing a burst of consumer (and business) spending, thereby keeping the economy from lapsing into recession.

Conclusions

I hope after reading this far you have begun to share my suspicion of the consensus view of the economy for 1981. Much as I would like to see the rather sanguine outlook described earlier and in the GNP table, I have learned from experience to expect the unexpected. It is too soon to tell which path the economy will take, but if you keep watch for the shocks I described earlier, you might get an early clue.

Of course, things don't unfold as neatly as I described above. That is—it is always possible that a combination of external shocks might hit the economy that would simultaneously tend to retard economic activity while at the same time boosting inflation and the expectation of inflation. As a matter of fact, we could already be heading toward such conflicting exogenous factors. For example, it does appear as though the Federal Reserve is erring on the side of monetary tightness. Even though the money supply has been flat on balance since the middle of the fourth quarter and loan demand at commercial banks has weakened somewhat, the Federal Reserve has not allowed the Federal funds rate to decline very much. This could be in response to several factors, but I would bet that one of them is the latent strength that the economy continues to exhibit.

You need look no further than the fourth quarter's figures on the gross national product to see what I mean. The fact that the economy could grow at a five per cent annual rate in the fourth quarter with interest rates approaching record highs and automobiles and housing in the doldrums is nothing short of phenomenal. When you add to this the very real possibility that the Administration will cut taxes, you can see where the potential for a collision of forces exists, and why I am reluctant to put all of my eggs in one forecast basket, so to speak.

But if I have to stick my neck out, I would guess that the rate of inflation and interest rates will be higher than many people now anticipate while the economy will be stronger in real terms as well. This is because it's going to take a lot more restraint than the Federal Reserve has already dished out in order to bring the economy down. At the same time, more and more people have not only learned to live with high rates of inflation and high rates of interest—some even look forward to it. In my next Report I will discuss who these people are and what their attitudes are doing to our national will to fight inflation and bring interest rates down. H

January, 1981

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

			< ACTUAL						PROJECTED >					
	YEAR 1979		1980				YEAR 1980		1981				YEAR 1981	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2413.9**	**12.0**	2571.7	2564.8	2637.3	2741.4	**2628.8**	**8.9**	2807.9	2882.9	2969.3	3062.6	**2930.7**	**11.5**
GNP: $72	**1483.0**	**3.2**	1501.9	1463.3	1471.9	1490.1	**1481.8**	**−0.1**	1486.7	1489.1	1496.5	1505.8	**1494.5**	**0.9**
% Change, Annual Rates	**3.2**		3.1	−9.9	2.4	5.0	**−0.1**		−0.9	0.7	2.0	2.5	**0.9**	
Consumption	**1510.9**	**12.0**	1631.0	1626.8	1682.2	1744.4	**1671.1**	**10.6**	1793.4	1847.2	1908.7	1968.8	**1879.5**	**12.5**
Durables	**212.3**	**6.5**	220.9	194.4	208.8	222.1	**211.5**	**−0.4**	224.1	232.5	240.9	250.1	**236.9**	**12.0**
Non-Durables	**602.2**	**13.7**	661.1	664.0	674.2	697.8	**674.3**	**12.0**	718.6	737.2	762.7	785.0	**750.9**	**11.4**
Services	**696.4**	**12.4**	749.0	768.4	799.2	824.5	**785.3**	**12.8**	850.7	877.5	905.0	933.7	**891.7**	**13.6**
Investment	**415.8**	**10.8**	415.6	390.9	377.1	403.7	**396.8**	**−4.6**	412.6	427.6	440.2	457.7	**434.5**	**9.5**
Non-Residential	**279.7**	**15.6**	297.8	289.8	294.0	297.3	**294.7**	**5.4**	302.6	310.1	316.0	329.2	**314.5**	**6.7**
Producers Durable Equipment	**183.4**	**12.3**	189.7	181.4	186.8	188.0	**186.5**	**1.7**	190.7	195.0	198.6	205.1	**197.3**	**5.8**
Structures	**96.3**	**22.4**	108.2	108.4	107.3	109.3	**108.3**	**12.5**	111.9	115.2	117.4	124.2	**117.2**	**8.2**
Residential	**118.6**	**6.6**	115.2	93.6	99.2	112.2	**105.0**	**11.4**	111.1	113.9	117.7	123.9	**116.6**	**11.0**
Inventory Changes	**17.5**		2.5	7.4	−16.0	−5.7	**−2.9**		−1.1	3.5	6.5	4.6	**3.4**	
Net Exports	**13.4**		8.2	17.1	44.5	34.5	**26.1**		31.1	28.5	26.6	23.3	**27.4**	
Government Purchases	**473.8**	**9.5**	516.8	530.0	533.5	558.8	**534.8**	**12.9**	570.8	579.6	593.7	612.7	**589.2**	**10.2**
Federal Defense	**111.2**	**11.3**	125.0	128.7	131.4	142.7	**132.0**	**18.7**	146.2	149.6	153.3	161.2	**152.6**	**15.6**
Federal Civilian	**56.7**	**6.1**	64.9	70.0	63.5	70.6	**67.3**	**18.6**	70.4	68.2	68.9	70.6	**69.5**	**3.4**
State & Local	**305.9**	**9.6**	326.8	331.3	338.6	345.5	**335.5**	**9.7**	354.2	361.8	371.5	380.9	**367.1**	**9.4**
Final Sales: $72	**1472.8**	**3.5**	1502.8	1462.0	1476.9	1490.3	**1483.0**	**0.7**	1487.3	1487.7	1493.7	1503.9	**1493.1**	**0.7**
% Change, Annual Rates	**3.5**		3.1	−10.4	4.1	3.7	**0.7**		−0.8	0.1	1.6	2.7	**0.7**	
GNP Price Index (1972 = 100)	**162.8**	**8.5**	171.2	175.3	179.2	184.0	**177.4**	**9.0**	188.9	193.6	198.4	203.4	**196.1**	**10.5**
% Change, Annual Rates	**8.5**		9.3	9.8	9.2	11.2	**9.0**		11.1	10.4	10.3	10.4	**10.5**	
PCE Deflator (1972 = 100)	**162.3**	**8.9**	172.9	177.0	180.7	185.0	**178.9**	**10.2**	190.2	195.2	200.3	205.2	**197.8**	**10.5**
% Change, Annual Rates	**8.9**		12.2	9.8	8.6	9.9	**10.2**		11.8	11.0	10.8	10.2	**10.5**	
Consumer Price Index (1967 = 100)	**217.6**	**11.3**	237.1	244.8	249.1	256.4	**246.8**	**13.4**	264.3	271.9	279.0	286.1	**275.3**	**11.5**
% Change, Annual Rates	**11.3**		16.9	13.7	7.2	12.3	**13.4**		12.9	12.0	10.9	10.6	**11.5**	
Total Personal Income	**1943.8**	**12.9**	2088.2	2114.5	2182.1	2259.1	**2161.0**	**11.2**	2315.3	2377.1	2456.6	2519.3	**2417.1**	**11.9**
Disposable Personal Income	**1641.7**	**12.2**	1765.1	1784.1	1840.6	1899.1	**1822.2**	**11.0**	1942.5	1991.2	2088.5	2138.2	**2040.1**	**12.0**
Savings Rate	**5.3**		4.9	6.2	6.1	5.6	**5.7**		5.2	4.8	6.2	5.6	**5.4**	
Employment Rate	**58.3**		58.3	57.6	57.5	57.4	**57.7**		57.4	57.3	57.7	57.9	**57.6**	
Unemployment Rate	**5.8**		6.1	7.5	7.6	7.5	**7.2**		7.7	7.9	7.7	7.5	**7.7**	
Indus. Production (1967 = 100)	**152.5**	**4.4**	152.5	144.6	142.1	148.9	**147.0**	**−3.6**	147.8	147.7	150.3	153.9	**149.9**	**2.0**
Housing Starts (000)	**1721.9**	**−14.3**	1263.3	1053.0	1411.7	1556.0	**1321.0**	**−23.3**	1314.2	1422.9	1479.0	1542.0	**1439.6**	**9.0**
Domestic Auto Sales (000)	**8230.1**	**−10.2**	7922.3	5488.0	6497.0	6668.3	**6643.9**	**−19.3**	6634.5	7008.6	7163.7	7445.4	**7063.0**	**6.3**
Corporate Pre-Tax Profits	**255.3**	**14.4**	277.1	217.9	237.6	248.1	**245.2**	**−4.0**	220.7	230.2	238.5	246.7	**234.0**	**−4.5**
− Taxes	**87.6**	**5.6**	94.2	71.5	78.5	80.3	**81.1**	**−7.4**	74.0	78.6	82.0	85.1	**79.9**	**−1.5**
Net Profits	**167.8**	**19.5**	182.9	146.5	159.1	167.8	**164.1**	**−2.2**	146.8	151.6	156.4	161.7	**154.1**	**−6.1**
− Dividend Payments	**48.6**	**12.8**	52.4	54.2	55.1	56.1	**54.5**	**12.0**	58.0	60.0	62.3	64.5	**61.2**	**12.4**
Undistributed Profits	**117.6**	**22.9**	128.9	90.7	102.4	111.7	**108.4**	**−7.8**	88.7	91.6	94.2	97.2	**92.9**	**−14.3**
+ Depreciation	**139.5**	**13.6**	151.7	155.4	160.5	165.3	**158.2**	**13.4**	196.3	200.3	204.9	209.4	**202.7**	**28.1**
− Inventory Profits	**42.6**	**75.4**	61.4	31.1	41.7	38.9	**43.3**	**1.5**	47.7	57.0	59.4	57.8	**55.5**	**28.2**
Net Cash Flow	**214.5**	**10.4**	219.2	215.0	221.2	238.1	**223.4**	**4.1**	237.3	234.9	239.6	248.8	**240.1**	**7.5**

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The Manufacturers Hanover
Economic Report

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Will It Work?

Contrary to the belief expressed in some quarters, President Reagan's economic proposals are neither an outright repeal of the economic theories of John Maynard Keynes, nor are based entirely on a new, untested economic theory. Rather, they are an amalgam of old and new. As such, the President's proposals are not as risky as their critics assert. On the other hand, their likelihood of success may not be as great as the Administration hopes.

Keynes Resurrected

First and foremost in the President's plan is the need to balance the Federal government's budget. The President wants to do this in order to make the Federal Reserve's job of slowing money growth easier. That is —when the budget is in or near balance, the Federal Reserve can slow the rate of increase of money and credit without precipitating a credit squeeze. And as I will discuss below, slower money growth is the *sine qua non* for permanently reducing the rate of inflation.

As I pointed out in my November Economic Report, Keynes never directly attacked the classical notion that the Federal government's budget must be in balance. He was very much in favor of a balanced budget during periods in which the economy was growing. He advocated the use of a budget deficit to provide unemployment relief during periods in which the level of employment declined. However, he did not place great emphasis on the implications of a budget deficit beyond that of stimulating the economy. This is because he believed that deficits should not be used as a main tool of economic policy, and when they were they were to be used during periods of economic slack. The record of the postwar years shows that we have departed from Keynes's basic notion of running deficits in bad times and surpluses in good times. The last time we had a surplus in the Federal government's budget was in 1969; the time before that was 1960. In the 37 years since the end of the second World War, we have had deficits in 29.

The President has wisely recognized the implications of this spate of budget deficits. Not only has it forced the Federal Reserve to expand the supply of money and credit faster than the economy's ability to grow thus producing the basis for inflation, it has opened the door for the Federal government to intrude in many aspects of American life. The "buy now, pay later" budget system that characterized fiscal policy during most of the postwar era provided a boon to elected officials. Politicians began parading before the American people, promising everything without presenting a bill. There always seemed to be Federal money available to remedy whatever local ailment existed. Little wonder that we got into the economic mess that the President says we are in today. Thus, far from repealing Keynes, I would say that the President is adhering to one of Keynes's basic tenets — the use of budget deficits only to provide unemployment relief.

Monetarism Retained

Another aspect of the President's economic plan deals with monetary policy. The Administration would like the Federal Reserve to restrain money growth. Quoting from the President's State of the Union message: ". . . Our plan requires a national monetary policy which does not allow money growth to increase consistently faster than the growth of goods and services. In order to curb inflation, we need to slow the growth in our money supply. We will . . . vigorously pursue budget policies that'll make (the Federal Reserve's) job easier in reducing monetary growth. A successful program to achieve stable and moderate growth patterns in the money supply will keep both inflation and interest rates down and restore vigor to our financial institutions and markets."

There is nothing new and untested about this aspect of the President's plan. It takes into account what monetarists in particular and most economists in general have said for a long time: The basic, fundamental cause of inflation is too much money chasing too few goods. While individual prices change all the time, the overall price level can only go up if there is an excess

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amount of money and credit in circulation. Through the years, the Fed has had difficulty holding money growth to the growth of real goods and services. This is because of the influence of the Federal government and its policy of running budget deficits year after year. When the Federal government runs a deficit in its budget, it has to borrow to make up the difference, just like when you or I spend more than we take in. The Treasury, being the top-rated borrower, gets the first shot at the credit markets, and everybody else has to fall in line for the rest. As I observed above, there have been only eight times since the end of World War II in which the Treasury did not have to increase its borrowing from the financial markets, because there were eight surpluses in the budget. The rest of the times there were deficits.

Because the economy generates only a certain amount of loanable funds each year, the more the government borrows, the less is available for the private sector. This does not affect the top-rated corporations, which have access to funds from various sources. It does affect those at the bottom of the credit totem pole, where people like you and I might stand if we were buying a house, a car or any other item that requires credit. If the Federal Reserve stood idly by and did not replenish the money that Washington took out at the top, we would get closed out of the markets. In this situation, a money panic would ensue; interest rates would go sky-high; a credit crunch would develop followed by widespread business failures and bankruptcies.

Because the Fed was created to put an end to the repeated panics that caused the economy to have many severe downturns, and because the Fed, like the Supreme Court during Franklin Delano Roosevelt's era, reads the newspapers, it has felt constrained to provide additional liquidity to the financial markets so that the private sector can get what it wants after the public sector has financed its needs. This is why the Federal Reserve over the years has produced more money than the economy has goods. In turn, this is why we have the inflation rates that we do. Quoting from testimony that Paul A. Volcker, chairman of the Federal Reserve, gave last year before Congress, "There is little doubt that inflation can not persist in the long run unless it is accompanied by excessive expansion of money and credit." To this the monetarists would add: Control the quantity of money and you control inflation. The President is relying on the Fed to do just that, hence my statement that he is drawing from monetarism in the construction of his economic plan.

Supply Management "Discovered"

One of the greatest misconceptions perpetrated by the popular press is the notion that supply-side economics is new. Nothing could be further from the truth! Supply-side economics has its roots in no less a person than the classical economist, Adam Smith. Some 200 years ago, Smith warned that "high taxes, sometimes by diminishing the consumption of the taxed commodities and sometimes by encouraging smuggling, afford a smaller revenue to government than what might be drawn from more moderate taxes." Another classical economist, Jean Baptiste Say, in his Law of Markets, developed the notion that "supply creates its own demand." This theory holds that there can never be a serious and continuing shortage of purchasing power because production automatically returns to producers the wherewithal to buy the goods that are produced. If goods are left unsold, the classical economists argued, prices would fall to the level where all the items would eventually be sold. Moreover, the presence of unsold goods means that consumption is falling and savings are rising. The increase in savings, in turn, forces interest rates down and pushes investment up. Thus slack in consumption is automatically offset by investment. Classical theory, therefore, holds that the cyclical ups and downs of an economy are merely phases in the process of an adjustment that tends toward full employment.

The Great Depression, with its lack of demand amid plentiful supplies, scotched this theory. Prices did not fall very rapidly, and savings failed to generate offsetting investment. Keynes argued that a shortage of purchasing power could grow progressively worse as consumers cut back expenditures and business responded by curtailing production and investment. Indeed, the economy could settle at exceedingly depressed levels of economic activity and high unemployment. This led him to come up with the notion that the government could boost demand by spending more than it takes in. In other words—Keynes believed that demand creates its own supply.

This worked for a while—until deterrents developed and began to outweigh the incentives created by increased demand. One of these deterrents was inflation, caused by years of deficit spending. Besides boosting interest rates, inflation distorted corporate balance sheets and pushed individuals into higher tax brackets. Thus our tax code, which at one time was neutral in its effects on investment conditions, had become a significant deterrent by retarding capital formation. In subsequent years other deterrents appeared. Businessmen became concerned with energy availability, the threat of controls and ever-increasing rules and regulations.

Several years ago a study by the Joint Economic Committee of Congress recommended removing these deterrents in order to slow inflation without having to keep economic growth at a reduced level. Signed by conservatives and liberals, Republicans and Democrats alike, this unanimous report was remark-

able in its espousal of supply-side economics. Focusing on economic growth through the encouragement of investment and production, supply-side economists see such growth arising from a free response to the economic incentives of a free market. What is more, they believe that only the private sector can bring us sustained growth, thus there is a need to reduce the role of the public sector. This hardly seems like a new, untested economic theory.

Central to the supply-siders in the Reagan Administration is a change in tax rates. The aim of President Reagan's tax cut is to stimulate supplies—not demand, as has been the case in the past. High tax rates are seen as a roadblock to economic growth, as a disincentive to labor and capital. The Administration is trying to alter economic behavior by expanding the rewards for production. People will have the incentive to work harder if they can keep more of their incremental wages. This would be accomplished by people working overtime, withdrawing from tax shelters, foregoing consumption, rejecting leisure, selling gold, purchasing stocks, starting a business, taking extra training or otherwise accepting additional risk to earn more money. Not only are workers supposed to work harder for incremental dollars, but investors are supposed to limit their consumption in order to earn more dollars in the future. The tax cuts are supposed to reduce the rewards of sheltering income from taxes through investments in untaxable activities or through work "off the books."

To me, this aspect of supply-side economics makes a lot of sense. As I have said in the past, we have long paid too much attention to demand management and not enough to conditions that generate increased supplies. More supplies of goods and services will not only hold down inflation by matching demand, but the newer, more modern machinery and equipment that produces these goods, by increasing labor productivity, will further help slow the rate of inflation by providing an important offset to ongoing wage increases.

So far so good. These three aspects of the President's economic plan are neither new in nature nor unreasonable in objectives. If and as the budget is brought into balance, the Fed will be able to slow money growth without precipitating a credit squeeze and high interest rates. This will allow the rate of inflation to slow while at the same time removing a major deterrent to new investment in the form of high interest rates. With an assist from tax cuts aimed at generating increased supplies, this new investment will bring forth a faster rate of growth for the economy, more goods and services, more jobs and profits. It is when we get to the fourth part of the basis for the President's economic proposals that I encounter some difficulty. Interestingly, this is the "new" aspect that I referred to at the outset.

Rational Expectations: New and Risky

Simply stated, rational expectations theory suggests that individuals respond not only to specific stimulus connected with actual events, but also to expectations about the future effects of current events and policies. To me, this is separate from the other theories that the President has espoused. This is because entirely different results can be predicted if one has reason to believe that the public's attitude will change, for whatever the reason.

For example, tax cuts are normally viewed as contributing to additional expenditures by those receiving the tax relief. If these cuts were to be considered as a means toward reducing inflation, people would not spend more, they would save more, instead. As for investors, they would shift their preferences from precious metals, real estate and other tangible assets to such financial assets as corporate bonds and Treasury securities, if they thought inflation was set to recede. This portfolio shift would increase the supply of funds to the capital markets so that interest rates would not rise—even if the Federal Reserve maintained a very tight rein on money growth.

This increase in savings and investment is supposed to work in the following way: First, if people really believe that inflation will abate, they will be less tempted to buy goods simply to avoid paying higher prices later. At the same time, they (and others with investable funds) would view the current level of interest rates as a great investment opportunity, since less inflation usually brings with it lower interest rates. Thus they would buy government and corporate bonds either for their high rate of return, or with the hope of selling later with a capital gain. Either way, this theory goes, the cut in government revenues that would accompany a reduction in taxes would be financed largely out of savings and not by the Federal Reserve creating new money.

For this to work, two key elements must occur. The first is that an across-the-board tax cut must be enacted. This would allocate much of the benefits toward the upper income groups that pay the most taxes and have the greatest propensity to save. If the President's tax cut proposals are altered by Congress so that upper-income families don't get as much tax relief as the President would like, it is possible that, rather than savings, consumption might be stimulated, since the tax cuts would be going largely to those with the greatest tendency to consume.

More important is the notion that people have to believe that the government will be able to reduce inflation. It is here that I have even more difficulty, since there has been a general distrust of government in recent years. I guess this goes back to the Vietnam War, and the efforts by President Johnson to conceal

its scope from the American people while he was escalating it. In the 1970s people did not believe the government when it told them there was an energy crisis. People in the parched Northeast don't believe their local governments today when they tell them that water supplies are dangerously low. And, I would bet, a good many people don't believe that President Reagan will be able to balance the budget any more than his predecessor, Jimmy Carter, who "promised" the electorate in 1976 that he would balance the budget by 1980.

Plainly, if the people do not believe that the President's policies will slow inflation, then they will spend, not save, and will not provide the wherewithal for the increased budget deficit to be financed. In the absence of this increased savings, one of two things will happen: Either the Federal Reserve will stand fast, in which case interest rates will rise, choking off both investment and consumption, or if the Fed accommodates, then inflation expectations will worsen with the same negative effects.

To make matters worse, many people have grown to accept inflation as a way of life, and have made significant adjustments to it. These include such people as those whose incomes are linked to the consumer price index, people who have bought homes, people who borrow money and even people who lend money and save money. It would seem to me that the President has to recognize that he has to address this "inflation constituency" first, and convince people that inflation is something that should not be adjusted to, before he can get people to believe that the government is really going to slow its pace.

In the main, I think that if the President's program survives the inevitable alterations by Congress, it stands a pretty good chance of succeeding. However, its probability of success would be greater if less attention were paid to the relatively new and untested rational expectations theory and more emphasis were placed on the traditional, well known and respected theories of balancing the budget, slowing money growth and providing additional economic incentives for business investment. It has taken a long time for the public to become aware of inflation and especially the government's role in it. I don't think it is reasonable to assume that the public's attitude is going to change overnight—especially on the basis of words, as opposed to deeds.

It would seem to me that people will change their attitudes toward inflation and the expectation of inflation only when they see a fiscal policy that contains a credible schedule for reducing the budget deficit, and a monetary policy that follows up with progressively lower growth targets for the supply of money and credit. If and as this occurs, it will first show up in a reduction of interest rates in both the short- and the long-term markets, for financial market participants will then demand less of an inflation premium for commitments of funds. At this point, it would be safe for the Administration to ask the Congress to pass its program of across-the-board tax cuts. For only then will there be a chance that people will save the proportion of the tax cut that its proponents hope for, in order to prevent the resulting increased budget deficit from forcing either interest rates or the rate of inflation higher. H

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There Is No Free Lunch

As I read about the anguish that is apparently being generated in many quarters by President Reagan's proposed cuts in the Federal budget, I wonder if people realize just where these funds come from. For all around the country, there are many people who seem to think that government money, particularly Federal government money, comes from some mysterious inexhaustible source. At least that's the way it seems to me, in view of the arguments they pose against cutting into their special interest programs. It's almost as though they think they have a "right" to tap the public well, since isn't that what it is there for?

I have what might be shocking news for these people, There are only two ways in which the Federal government can get money to spend. One way is to tax, the other is to borrow. Together they make up the true burden that the government imposes on the economy for they add up to total government spending. What these special interest groups would have us do in order to continue funding their various programs is to maintain — or possibly enlarge — the total burden of government on the economy in order that their particular interests be satisfied.

Special Interests Vs. The Nation's

Jimmy Carter put it quite appropriately in his farewell address to the Nation last January. "...We are increasingly drawn to single-issue groups and special-interest organizations to insure that, whatever else happens, our own personal views and our own private interests are protected. This is a disturbing factor in American political life. It tends to distort our purposes because the national interest is not always the sum of all our single or special interests." I would agree, and add: There is no such thing as a free lunch.

Scarcely a day goes by without one special interest group or another preparing to do battle over the Administration's proposed budget cuts. Indeed, a national coalition of trade unions, civil rights groups, religious organizations and social welfare agencies has already been established with the intent of protecting their members from the budget ax. The arguments their leaders use are compelling. They want to "fight against the unnecessary and unwise destruction of social and economic advances in the past 50 years," in the words of one prominent member. "Americans must tell the President and they must tell Congress that they will not sit still for this reactionary program," said another. "From poor to worse," observed the headlines of a major newspaper. The cuts would "drive more into the ranks of the truly needy," added another. And a prominent columnist took special pains to report that more than "300 social assistance programs — including food stamps, child nutrition, welfare, housing, unemployment benefits, jobs and training, education, scientific research, Medicaid and black lung, fuel-oil subsidies, legal aid for the poor, environmental protection, disaster and flood insurance, and veterans' benefits — " were earmarked for the budget ax.

The defense establishment is not acting any differently. Military personnel have rushed to Capitol Hill with their special requests over and above the hefty increase proposed by President Reagan. And, I might add, Jimmy Carter's defense budget for 1981 called for a sharp rise to begin with.

Three Options

All of this handwringing and beseeching looks toward Washington and cries that the Federal government should pour Federal money into various special interest programs means that these people want one of three things to happen. Either the Federal government should raise taxes in order to get the money to pay for these programs. Or Washington should borrow more from the private sector — raising interest rates in the process. Or Washington should borrow more from the Federal Reserve — raising prices, instead. There is no other way. There is no such thing as a free lunch.

Let us examine each of these particular "options" closely. Supreme Court Justice John Marshall once said that the power to tax involves the power to destroy. By that criterion we have done more dam-

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age to ourselves than any other foreign nation has done in a war. Our tax burden today stands at 32 per cent. That is — personal taxes of all kinds now account for 32 per cent of personal incomes. This is up 7.6 percentage points in 20 years.

This mounting tax burden has slowly but surely affected our ability to grow. In the past 10 years, the gross national product adjusted for inflation has expanded at a 3.6 per cent annual rate compared with 4.7 per cent in the previous decade. Recognizing this, President Reagan has proposed a program of sweeping tax cuts for individuals as well as businesses. While one might quibble with the exact timing of these tax cuts, in view of the sizable deficit that still exists in the Federal budget, there is no denying that the tax burden has to be lowered — and the sooner, the better.

That leaves government borrowing. Here the tab has risen even faster. In fiscal year 1980 Washington raised $119.1 billion to finance its on-and off- budget expenditures. This represented 35.7 per cent of total funds raised in the money and capital markets, and compares with 17.6 per cent just 10 years earlier. Not surprisingly, this increased presence in the financial markets by the Federal government was one of the reasons why interest rates were so high last year. In case you have forgotten, interest rates on six-month Treasury bills averaged 11.4 per cent in 1980: 10 years earlier these rates averaged 6.5 per cent and 10 years before that 3.2 per cent.

Of course, instead of borrowing from the private sector, Washington could always borrow from the Federal Reserve. Indeed, this has been the case more often than not. But borrowing from the Federal Reserve has the effect of creating money. And since Washington's budget deficit has been growing faster than the economy, the Federal Reserve has wound up creating money at a faster rate than our ability to produce real goods and services. When more money is in circulation than there are goods and services, it tends to lose value — in other words, we have inflation. And as readers of this Report should be well aware by now, inflation is our number one economic problem. This year we will very likely have another dose of double-digit inflation. That would make it three years in a row in which prices have gone up by ten per cent or more — a record not matched in half a century!

To be sure, the public at large would like to see a balanced budget. The only problem is — people have little enthusiasm for the cuts in Federal spending that would have to take place in order to get the budget in balance. This is not to say that people are not in favor of tightening belts. However, it always seems as though they want someone else's belt tightened, not theirs.

What It All Means

When people advocate that Washington should continue to pour Federal money into their special interest programs they are in effect saying that one of three things should come to pass. They are saying that the Federal government should continue the present rate of taxing of those who have in order to give to those who don't. Or they are saying that the Federal government should continue to borrow from the private sector to give to those who are unable to borrow on their own. Or they are saying that the Federal government should further erode the value of the dollar through more inflation in order to get funds to give to those who don't have.

There is no other way. There is no such thing as a free lunch.

The Problems Transcend The Federal Government

Although the precarious state of Federal government finances has preoccupied much of the attention of the financial press, it should not be allowed to overshadow some equally severe strains which continue to plague the private sector. The combination of high inflation rates and high interest rates continues to erode the financial strength of households and businesses, limiting their ability to expand spending and investment for any prolonged period of time. What is more, correcting the existing imbalances may well cause a pause in the pace of consumer and business spending later this year, limiting both the magnitude and duration of the anticipated rebound in the economy.

The likelihood of a downturn in consumer and business spending diminishes considerably, however, with the implementation of personal and business tax reductions. These cuts significantly enhance household and business liquidity, which would be required for stepped-up physical and financial asset acquisition and accelerated economic growth. But while bolstering near-term financial positions in the private sector, they may exacerbate the more fundamental problems that caused the deterioration in the first place—high rates of inflation and the massive Federal budget deficits that helped produce them.

Household Finances Need Improvement...

Much of the recent gain in retail sales was fueled by the strengthening of household finances which occurred earlier. However, these limited improvements in household balance sheets were probably not sufficient to support a sustained upturn in consumer spending this year. In fact, many of the improvements have already begun to reverse themselves, despite a still cautious consumer outlook. For example, although installment debt liquidations as a

percentage of disposable income currently stand well below their mid-1979 high, they have been rising modestly since last fall.

Another measure of household liquidity—the household debt service burden, which consists only of interest payments on both mortgage and installment debt service payments as a percentage of disposable income—has also been rising in recent months. It stood at eight per cent in the fourth quarter of 1980, the second highest level ever, and with interest rates remaining at lofty levels, could move even higher. Finally, the savings ratio has begun to drop once again. After climbing as high as 6.2 per cent in mid-1980 (expressed in relation to disposable income), it has since ratcheted downward sharply, falling to 4.4 per cent in January, 1981. This was a new record low and almost one-half of one per cent below month-earlier levels.

The correction of this renewed weakness in household finances may result in another period of sluggish consumer spending unless offset by a cut in taxes. Sizable personal income tax cuts would boost household cash flows substantially, stimulating spending and financial asset acquisition, and prompting good-sized increases in both growth rates and savings rates.

...As Do Corporate Finances

One of the areas of economic activity most vulnerable to the adverse effects of high inflation and high interest rates is business fixed investment. Weak balance sheets, high interest rates and unstable bond markets have tended to dampen externally-financed investment spending while sluggish profits growth has hampered internally-financed expenditures.

During the past year, for example, extensive short-term borrowings by U.S. business (reflecting in large part the lofty yields prevailing in the bond markets) led to a marked deterioration of corporate balance sheets. With commercial and industrial loans outstanding at large weekly reporting banks increasing by almost $20 billion during the twelve months ending December, 1980 (following a $23 billion gain during the same period in 1979), commercial paper issuance by nonfinancial corporations rising by almost $7 billion and short-term interest rates reaching historic highs both early and late in the year, it is hardly surprising that some key indicators of corporate financial health deteriorated. One measure of liquidity, the ratio of short-term to total liabilities jumped from 36 per cent in 1978 to 39 per cent by end-1980, a record high. The debt service burden also rose sharply during the period, with the percentage of gross internal funds required to service existing debt rising from approximately 26 per cent in 1978 to more than 40 per cent in the fourth quarter of 1980.

Corporate profits growth also remained sluggish. Although after-tax profits advanced 3.1 per cent in the fourth quarter, compared with quarter-earlier levels, they still stood 2.4 per cent below the comparable quarter a year ago and more than ten per cent below their first quarter peak. Much of the beneficial impact of an increased level of economic activity in the last quarter of 1980 was offset by a further escalation in the cost of doing business, especially sharp increases in labor, energy and financing costs.

Nor is the weakening of corporate financial positions expected to be reversed quickly. High interest rates will continue to swell debt service burdens to levels well above those prevailing at comparable stages of previous economic cycles. High inflation rates will continue to generate bouts of extreme instability in the bond markets, hindering complete recovery in the relative term structure of corporate liabilities. Finally, business profits growth will remain subdued, reflecting the sluggish pace of real economic growth, while, at the same time being eroded by high inflation and high interest rates.

And while the cash flow bolstering effects of substantial business tax cuts will provide a sharp boost to corporate liquidity, it alone will not correct existing problems. In fact, the impact of such reductions may be largely offset by higher inventory replacement costs and the upturn in capital spending expected during the latter half of 1981 and 1982. But at least such cuts will provide some additional resources to business to increase capital spending without additional recourse to external finance or further impinging upon existing internally-generated funds. However, with long-term borrowing costs still lofty and the bond markets still volatile, business firms will continue to rely on expensive, short- and medium-term financing for a substantial proportion of their borrowing requirements. As a result, the complete restoration of corporate liquidity positions will again be deferred.

In summary, strains developing, and already existing, within the household and corporate sectors of the economy could limit the strength and duration of the economic rebound. In each instance, the ability of consumers and business to sustain real spending levels has been eroded by a prolonged period of high rates of inflation and the resulting high interest rates. Although the tax cut proposals of the Reagan Administration will go a long way toward enhancing the spending and investing capabilities of households and business, their stimulative impact will only be short-lived unless more fundamental solutions to the existing economic problems appear on the horizon. The requirements: Increased investment and enhanced productivity economy-wide—the attendant benefits of a prolonged period of fiscal and monetary policy restraint on the part of the public authorities.

—Marc M. Goloven, Vice President

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

APRIL 1981

Quarterly Business Conditions Analysis

Practically since its inception, economics has been known as the dismal science. I don't want to go into great detail about past history, but this appellation has certainly been appropriate in recent years. Scarcely a calendar quarter has gone by in the past two years when a recession was not forecast to begin imminently by one economist or another. Indeed, I have had my share of forecasted downturns that never came.

It is with this in mind that I would hope that the reader will pay careful attention to the analysis I spell out below. For in it I hope to make the case that the near-term outlook is not as gloomy as some forecasters expect. To be sure, I do not believe that the economy will continue to grow at the sizzling 6.5 per cent pace reported for the first quarter. However, neither do I look for the economy to lapse back into recession. Rather, I think that growth will continue — albeit at a more subdued pace. The slowdown will be most pronounced during the current quarter, then economic activity will pick up the beat as the second half gets under way. By yearend, growth may be at its highest point since the opening quarter of 1981 (see table).

Don't Underestimate The Consumer

In preparation for undertaking the quarterly forecasting exercise, I went back and examined our forecasts for the past three years. One thing struck me, and that was an almost consistent underestimation of the strength of the consumer sector. This is no small error, since consumer spending plays a very crucial role in the U.S. economy, accounting for about two-thirds of the gross national product. Clearly, the consumer had to have been in better financial shape than the reported economic statistics indicated.

In trying to determine how much better off people were than we were led to believe, we came upon some sources of buying power that do not show up in the income statistics — but do show up in sales and other numbers when people spend. None of these sources of buying power is new, in the sense that they have not been talked about before. However, it would appear that their cumulative influence on consumer spending habits is beginning to outweigh that of the reported data, causing most econometric models and their users to veer sharply from actual events. Add to this the better financial position that some of the *reported* economic numbers are signaling and I come to the conclusion that, as long as confidence remains bright, people will continue to spend.

That consumer confidence remains strong can be indicated from two recent sources. The Conference Board's regular survey of consumer attitudes shows a distinct brightening in March as optimism over future business and employment prospects changed for the better. In addition, several surveys of public opinion show that people seem to have a very positive impression of President Reagan's economic program, and as long as its chance for passage remains high, their attitudes will be favorable. Ironically, some folks have an attitude toward inflation that, while a reflection of lack of confidence in the Administration's economic program, nevertheless could bolster spending in the near-term. The more people think prices will go up, the sooner they may be tempted to "buy now and avoid paying higher prices later."

The first potential source of buying power that I would like to refer to is the so-called underground economy. Estimated to equal anywhere from one per cent to one-third of the gross national product, the off-the-books economy is universally agreed to be growing rapidly. Whether it is actual cash income that goes unreported, or income derived from bartering one's services for another's, the underground economy clearly contains a sizable pool of buying power. The figures most widely accepted are those that equal ten per cent of the GNP, or some $265 billion. Some of these

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funds may never see the light of day, but even if only two-thirds of them were to enter into the spending stream, they would lift the current rate of personal consumption expenditures by ten per cent.

A lot of negative forecasts have been generated based on low savings as reported in the national income account (NIA) statistics. But these numbers are statistically suspect. What is more, a recent revision in the data revealed that people had been salting away an average of $9 billion more per year than the government previously thought. In addition, NIA statisticians do not consider as savings the repayment of debt, yet it is in a sense because it builds up one's buying power just the same as if one were putting the money in a savings account, certificate of deposit, Treasury bill, etc. The government produces a series that takes this broader concept into account. A part of the Flow of Funds, the savings statistics generated from this source show approximately twice as much savings in the economy as would be suggested by NIA data. What is more, the ratio of Flow of Funds savings to take-home pay has not dropped over the course of the 1970s the way the NIA ratio has.

Unlocking The Increased Value Of Homes

The biggest chunk of potential buying power is the one that is growing the fastest, becoming more and more important to most people, yet is the hardest to get a precise handle on. This is the purchasing power that people have gained through the years as their homes have risen steeply in value because of soaring inflation. We tried to calculate just how much this represents. Taking the median value of owner-occupied housing units and multiplying that by the total number of units as estimated by the Census Bureau produces a gross value of homes approaching $2 trillion at the end of last year. Subtracting from this the approximately $1 trillion in mortgage debt outstanding for these homes reported by the Federal Reserve leaves about $1 trillion in unmortgaged value of housing that could be tapped.

To put this number in perspective, it is the equivalent of 55 per cent of after-tax income, $1.8 trillion, reported by the government for individuals last year. In recent years this figure, the unmortgaged value of homes, has grown even faster than the general price level for goods that consumers purchase. From 1973 through 1979 the personal consumption expenditures deflator rose by about 50 per cent. By contrast the unmortgaged value of owner-occupied housing went up by 150 per cent. This dramatic increase in the "real" value of household equity has proven mighty tempting to consumers — by an increasing amount in recent years.

To document this we traced the trend of mortgage debt outstanding adjusted for inflation compared with housing starts (which are a unit, or "real" figure). We found that, whereas housing starts in 1980 were only 63 per cent of their 1973 levels, real mortgage debt was 20 per cent greater. With more and more articles appearing in personal finance-type publications showing consumers how to "unlock" the increased value of their homes for such purposes as travel, college for the children — and even a car — it stands to reason that this is becoming a more and more important source of income even for those who don't sell their homes. Needless to say, those who do sell find this source of buying power literally dumped into their lap.

Aside from these "unreported" sources of buying power, those that economists have been able to monitor appear to be flashing brighter signs. For one thing, after a modest dip in February, total manhours worked in manufacturing industries rose in March. This helped personal incomes post a larger gain in March than the 0.7 per cent rise in February. When taxes are taken out and an adjustment is made for inflation, total consumer buying power from incomes in the twelve months ending March 1981 was up substantially, after having fallen earlier. (The big slide in personal incomes last year did not get underway until April.)

People Can Borrow—If They Choose

Then there is the use of credit. The old rule of thumb used to be that when repayments on installment debt took 15 per cent or more of take-home pay to service, people would generally be in a financial bind and would have to cut back their expenditures. However, as the 1960s melted into the 1970s, 15 per cent became 16 per cent, then 17 per cent. By the end of the 1970s, people were able to handle installment debt repayments amounting to as much as 18 per cent of take-home pay before finding it necessary to cut back. If one looks at this statistic at face value, one can be moderately optimistic, since it now takes little more than 16 per cent of take-home pay to service installment debt — down from the record of 18¼ per cent set in 1979. However, even this may not be as bad as it looks since more and more installment debt numbers include credit-card buying. Unlike other forms of consumer credit, credit-card debt tends to be paid off relatively quickly, since it reflects a form of convenience buying by people who don't want to carry much cash around. Clearly, as this debt is paid off, new debt can be assumed. Thus more borrowing — hence buying — power may exist than can be discerned by looking at the debt figures alone.

Besides installment debt, mortgage repayments as a percentage of disposable incomes are down, too. In

this case, it is a reflection of the slump in the housing market of the past two years as housing prices and mortgage interest rates soared to stratospheric levels. It is also a reflection of personal incomes growing while existing mortgage debt, in virtually all cases, has remained static. Whatever the reason, and in light of the points I noted above regarding the unmortgaged value of owner-occupied residences, it would appear as though many families might be in a position to take on more mortgage debt — possibly by securing a second mortgage — to finance increased expenditures.

The flip side of this reduced use of debt can be seen in the numbers dealing with the percentage of retail sales made with the help of credit. In 1978 and 1979 almost four out of every ten retail sales dollars were rung up with the help of installment debt. This plunged to little more than 28 per cent a year ago in the wake of the misinterpretation on the part of many people of the Federal Reserve's credit controls program. It has since rebounded — but only to about one-third, suggesting that more intensive use of debt to finance expenditures is possible.

I noted earlier that some people have an attitude towards inflation that is diametrically opposed to that which the Administration is trying to generate. That is — they continue to fear higher prices and are buying ahead of schedule in order to beat them. According to Lyle E. Gramley, a member of the Board of Governors of the Federal Reserve System, "anticipations of inflation are virtually as strong now as they were at their worst early last year." He attributes this to the underlying strength in the economy, noting that the steep but short recession of 1980 had relatively little effect either on the underlying inflation rate or on the public's perception of the outlook for prices.

On the other hand, there are those whose attitudes toward inflation have brightened — either because of the Administration's program and its commitment to lowering the rate of inflation, or in a response to events around them. Specific reference is made to the rebates offered by Detroit, which got people into the marketplace pretty quickly, not to mention the give-backs many unions have proffered in a variety of industries in response to soft labor market conditions.

Business And Government Will Lend A Hand

If and as the consumer increases the pace of spending, business will find it necessary to respond by restocking inventories. The latest reading of the critical inventory-sales ratio taken by the Commerce Department shows that stocks are just a tad above recent record lows relative to sales. While the use of computers and more intensive management techniques have lowered the long term trend of inventories relative to sales, and while the disparate rates of inflation on inventories and sales may make the "nominal" ratio look lower than the "real" ratio, it cannot be denied that inventory levels in many industries are precariously thin. This is the case if only because of the persistent warnings of recession sounded by economists.

In addition to restocking inventories, business will find it expedient to lift spending on new machinery and equipment as the so-called business tax cut works its way through the Congress. Then there is the boost to business attitudes that has already been generated by the Reagan Administration's lifting or canceling of many rules and regulations. On the government side, we have defense spending, which even before the Reagan Administration has had a chance to make its mark felt, is rising at the fastest rate since the Vietnam War. And if the President has his way, it will go up even faster. Needless to say, this sector is affecting prospects for a wide variety of industries in many regions of the country.

Where I come out, then, is on the side of those who acknowledge that the economy may grow more slowly over the next few months — but will not lapse into recession. This is not to say there may not be some down months immediately ahead. Indeed, our projection for the second quarter's average growth rate is so miniscule that it falls within the realm of statistical error as far as a potential minus is concerned. However, any dip should be brief, as long as the economy continues to be supported by the forces I have described above.

Time For Some Optimism

Hopefully, as the year wears on, the economy will regain strength while at the same time inflation and the expectation of inflation will moderate. This belief is based, not only on the Reagan economic plan, but also on such factors as stable energy prices and prospects for good harvests down on the farm. With a little luck we could cross the finish line at yearend with the best of all possible worlds: a rising economy with declining inflation rates and lower interest rates as well.

Given all the things that have gone wrong in recent months, this may seem overly optimistic. However, the time is ripe for a little optimism — especially after all the gloomy forecasts of the past few years. M

April, 1981

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< ACTUAL				PROJECTED >							
	1980		YEAR 1980		1981				YEAR 1981		1982	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2637.3	2730.6	**2626.1**	**8.8**	2826.8	2898.6	2977.2	3066.2	**2942.2**	**12.0**	3158.3	3251.2
GNP: $72	1471.9	1485.6	**1480.7**	**−0.2**	1509.2	1512.8	1520.7	1530.3	**1518.3**	**2.5**	1541.9	1553.8
% Change, Annual Rates	2.4	3.8	**−0.2**		6.5	1.0	2.1	2.5	**2.5**		3.1	3.1
Consumption	1682.2	1751.0	**1672.7**	**10.7**	1805.4	1854.0	1907.9	1959.5	**1881.7**	**12.5**	2010.9	2063.0
Durables	208.8	223.3	**211.9**	**−0.2**	238.1	240.5	250.6	256.1	**246.3**	**16.3**	260.5	265.2
Non-Durables	674.2	703.5	**675.7**	**12.2**	724.4	743.6	760.3	777.3	**751.4**	**11.2**	796.3	814.8
Services	799.2	824.2	**785.2**	**12.8**	842.8	869.9	897.0	926.2	**884.0**	**12.6**	954.0	983.1
Investment	377.1	397.7	**395.3**	**−4.9**	423.1	437.3	450.3	467.9	**444.7**	**12.5**	492.5	518.2
Non-Residential	294.0	302.1	**295.9**	**5.8**	314.7	319.5	327.4	338.2	**324.9**	**9.8**	348.7	361.7
Producers Durable Equipment	186.8	190.7	**187.1**	**2.0**	198.5	201.3	205.2	210.6	**203.9**	**9.0**	216.9	224.9
Structures	107.3	111.5	**108.8**	**13.0**	116.2	118.2	122.1	127.5	**121.0**	**11.2**	131.8	136.8
Residential	99.2	113.0	**105.3**	**−11.2**	116.3	114.4	114.0	118.3	**115.8**	**10.0**	127.0	137.7
Inventory Changes	−16.0	−17.4	**−5.9**		−7.9	3.4	8.9	11.4	**3.9**		16.7	18.8
Net Exports	44.5	23.3	**23.3**		24.3	19.4	18.2	20.2	**20.5**		22.4	23.6
Government Purchases	533.5	558.6	**534.7**	**12.9**	574.1	587.9	600.8	618.6	**595.3**	**11.3**	632.5	646.3
Federal Defense	131.4	141.6	**131.7**	**18.4**	144.9	150.0	154.0	165.2	**153.5**	**16.6**	169.8	174.0
Federal Civilian	63.5	70.4	**67.2**	**18.5**	74.8	75.4	75.1	74.3	**74.9**	**11.5**	75.2	75.6
State & Local	338.6	346.6	**335.8**	**9.8**	354.5	362.5	371.7	379.1	**366.9**	**9.3**	387.5	396.7
Final Sales: $72	1476.9	1492.7	**1483.6**	**0.7**	1515.0	1511.2	1516.7	1525.3	**1517.1**	**2.3**	1534.7	1546.0
% Change, Annual Rates	4.1	4.3	**0.7**		6.1	−1.0	1.5	2.3	**2.3**		2.5	3.0
GNP Price Index (1972 = 100)	179.2	183.8	**177.4**	**9.0**	187.3	191.6	195.8	200.4	**193.8**	**9.2**	204.8	209.2
% Change, Annual Rates	9.2	10.7	**9.0**		7.8	9.5	9.0	9.7	**9.2**		9.2	8.9
PCE Deflator (1972 = 100)	180.7	184.9	**178.9**	**10.2**	188.5	192.7	196.7	200.7	**194.7**	**8.8**	205.3	209.6
% Change, Annual Rates	8.8	9.6	**10.2**		8.0	9.3	8.5	8.5	**8.8**		9.3	8.7
Consumer Price Index (1967 = 100)	249.2	256.9	**247.0**	**13.5**	263.6	270.0	275.9	281.6	**272.8**	**10.5**	286.8	291.7
% Change, Annual Rates	7.8	12.9	**13.5**		10.8	10.1	9.0	8.6	**10.5**		7.6	7.0
Total Personal Income	2182.1	2256.2	**2160.3**	**11.1**	2317.7	2379.3	2453.2	2512.4	**2415.6**	**11.8**	2576.3	2640.7
Disposable Personal Income	1840.6	1897.0	**1821.7**	**11.0**	1945.5	1993.3	2056.0	2134.0	**2032.2**	**11.6**	2185.0	2237.2
Savings Rate	6.1	5.1	**5.6**		4.7	4.5	4.7	5.8	**4.9**		5.6	5.4
Employment Rate	57.5	57.4	**57.7**		57.7	57.7	57.8	58.2	**57.9**		58.5	58.7
Unemployment Rate	7.5	7.5	**7.1**		7.3	7.4	7.5	7.1	**7.3**		7.0	6.9
Indus. Production (1967 = 100)	142.1	149.1	**147.1**	**−3.6**	151.5	151.3	153.1	156.4	**153.1**	**4.1**	159.9	162.6
Housing Starts (000)	1390.0	1534.7	**1303.5**	**−24.0**	1386.0	1304.3	1388.9	1521.0	**1400.0**	**7.4**	1669.4	1792.1
Domestic Auto Sales (000)	6497.0	6668.3	**6643.9**	**−19.3**	7418.0	6836.5	7446.1	7628.4	**7332.2**	**10.4**	7872.9	8071.8
Corporate Pre-Tax Profits	237.6	249.5	**245.5**	**−3.8**	245.6	222.2	226.6	240.1	**233.6**	**−4.8**	240.0	252.2
− Taxes	78.5	85.2	**82.4**	**−6.0**	83.3	75.0	76.7	81.8	**79.2**	**−3.8**	81.4	85.3
Net Profits	159.1	164.3	**163.2**	**−2.7**	162.3	147.1	149.9	158.3	**154.4**	**−5.4**	158.6	167.0
− Dividend Payments	56.7	57.7	**56.0**	**11.7**	59.6	61.5	63.3	65.1	**62.4**	**11.4**	66.9	68.7
Undistributed Profits	102.4	106.6	**107.2**	**−8.9**	102.7	85.6	86.6	93.2	**92.0**	**−14.1**	91.8	98.2
+ Depreciation	160.5	165.4	**158.3**	**13.4**	170.6	202.4	207.6	212.7	**198.3**	**25.3**	231.2	236.9
− Inventory Profits	41.7	48.4	**45.6**	**7.1**	38.4	42.7	41.8	46.1	**42.2**	**−7.5**	48.6	48.6
Net Cash Flow	221.2	223.6	**219.8**	**2.4**	234.9	245.4	252.3	259.8	**248.1**	**12.9**	274.3	286.5

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MAY 1981

Where Is It Written?*

The late George Meany is reported to have said that economics is the only profession where a person can gain great eminence without ever being right. The Russian economist, Nikolai Dmitriyevich Kondratieff, wasn't quite as lucky. He was arrested and executed for his theory of the superlong business cycle which apparently contradicted the Communist notion that the capitalist system would decline and inevitably collapse.

Considering the flack economic forecasters have run into in recent years because of their seeming inability to predict the course of economic events, I wonder if people realize that there are no infallible crystal balls — in economics, or anywhere else. What is more, no one ever said that there was.

Nowhere in the standard dictionary definitions of economics and economists is there any reference to forecasting or predicting. The same is true, I might add, of meteorology, an equally abused discipline. Yet, businessmen and governments must look to the future in formulating strategies. And just as people don't stop looking at the weather forecasts in their daily papers simply because the weathermen have been wrong more often than they have been right, people need to know what the economy will be like, and are eager to get opinions, no matter how ill-founded most of them may be.

We All Try To Look Ahead...

The idea of wanting to look ahead is almost as basic as life itself. People forecast all the time without realizing it. When one chooses a career, buys a house, gets married or has a child, one is forecasting that the pluses of those endeavors will outweigh the minuses. When one crosses the street, one makes an implicit forecast that one will not be struck down as one attempts to reach the other side. But it is a long way from this, to the attempts by economists to forecast hundreds of statistics far into the future to five significant numbers.

The early economists were explainers rather than forecasters. They were more interested in learning how the economy operated rather than in predicting its performance. In the 1930s, this analytical process helped develop our national income accounting system, which produces the gross national product statistics that receive so much publicity these days (and which we all try so hard to forecast).

While there may have been some attempts to look ahead as the 1930s wore on, economists did not make forecasting an integral part of their work until after World War II. At that time, there were widespread fears that, without the stimulus of defense spending, the U.S. would lapse back into depression. The Employment Act of 1946 was passed, and the Council of Economic Advisers established as a means of keeping policymakers informed about economic trends and tendencies. But even then the aim was not so much to predict the onset of the next business cycle as to prevent it.

As government grew to depend more on economic analysis, businessmen took notice and began to hire economists, too. From a modest beginning at a few major banks, economists soon landed jobs with companies in virtually all industries in all parts of the country. It didn't take long for both the private and the public sectors to realize that economics could be useful in formulating strategies. However, the evolution of the idea that economists are primarily soothsayers probably was derived more from business and government needs for forecasts than from a desire on the part of economists to adopt that role. Not that we have fared all that badly; there has been a pretty strong job market for economists for quite some time, as Mr. Meany's statement implies.

In the process of crystal ball gazing, many economists have lost sight of what economics is all about. It is a social science concerned with the determinants of the

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ways in which goods and services are produced and exchanged, and with the allocation of the income from production among the various claimants upon it. A specific level of gross national product, employment, inflation or whatever has no particular importance by itself. What is important is the process by which that level evolved, its implications for future improvement in economic well-being and its social and political consequences.

The Reagan Administration has been severely criticized for basing its economic game plan on an economic theory which is not only new, but not susceptible to quantification in the form of an econometric model. However, econometrics, for all of its early billing, has not done any better as a forecasting device than any other method — no matter what theory the model is based on.

Although it is largely used today as a forecasting tool, econometrics originally was developed as a means of attempting to understand the economic process. Using mathematics and modern statistics, econometric models incorporated formulas whose components were variables that characterized different aspects of the economy. Each model attempted to include the appropriate number of variables, and tried to portray their relationship to one another so that by changing one, economists and policymakers might see what would happen to the others.

When model builders attempted to use these for forecasting, they came a cropper for several reasons. For one thing, the data fed into these models were frequently revised. For another, relationships between economic variables, and people's reactions to economic, political and social developments tend to change over time, something that mathematical models, which are based on extrapolating past developments into the future, can not pick up.

Speaking about external developments, there have been so many unusual things that have happened over the past decade that if anybody did manage to forecast correctly, it would have been by the sheerest of coincidences. No economist, perched at the beginning of the last decade, could have anticipated, for example, two freezes and four phases of wage-price controls, the OPEC oil shocks, the resignation of a president and a vice president, not to mention the erratic changes in weather patterns which caused crop failures in many parts of the world and the anchovies to disappear off the coast of Peru!

...But Economists Should Analyze More

Before I am ostracized from the profession altogether, let me observe that economists still have an important role to play. However, less emphasis ought to be placed on forecasting and more on explaining. By this I mean that since most of us do keep our fingers on the pulse of the economy, our views of current events and the possible implications of social, economic and political behavior would seem to be useful. The same would seem to be the case for our assessments of the effects of various economic policies that might be under consideration at a given time.

As long as they keep in mind that the "real world" changes constantly — including the fact that people are becoming more and more sophisticated about economics and tend to react to forecasts in ways which can cause them either to come true or to be wrong — economists will be performing a useful service. As for forecasting, a good rule of thumb is to remember the advice given by the late Professor Marcus Nadler: "If you have to forecast, do it frequently." ■

The EMS: A System Under Stress

The European Monetary System (EMS) was established in March, 1979 to create a "zone of monetary stability" among the currencies of the members of the European Economic Community (EEC). Eight of the nine members of the EEC joined the EMS. The United Kingdom opted to stay outside this system. The intent of the EMS was to reduce the volatility of the foreign exchange rates between the member currencies, which is characteristic of a floating exchange rate system, and to regain some of the advantages of the fixed rate system which came to an end in the early 1970s. Among these are the ability to undertake long-term investments with less uncertainty about future costs and benefits and to improve trading relationships through price stability. Further, it was hoped that the EMS would eventually lead to a convergence of economic policies and performance among members — and eventually to a common EEC currency.

The essence of the EMS is coordination and cooperation, both explicitly and implicitly. Explicitly, members are called upon to maintain the parity relationships within a relatively narrow band — 2.25 per cent on either side of the central rate for the currencies of Belgium, Denmark, France, Germany, Ireland, Luxembourg and the Netherlands and six per cent for Italy. Intervention in the exchange market to maintain these relationships is obligatory for any member whose currency threatens to go beyond the band. Implicitly, member countries are expected to modify their economic policies whenever an established "divergence threshold" is reached, indicating a fundamental shift in economic relationships; either a longer term strengthening or weakening of a member's economy against the others. This further implies a move toward

a convergence of economic policies of all members. It is this latter goal which creates the greatest difficulties for the system and may be the cause of its ultimate disintegration or fundamental modification. In practice, when the divergence threshold has been reached, the EMS has opted to adjust the central parities rather than demand that a member undergo the rigors of fundamental policy adjustments. This, of course, defeats the purpose of fixed rates.

Essentially, the EMS is an agreement of eight national economies to move forward together at the same rate. It is analogous to a company of soldiers marching in step, moving at the same pace and in the same direction in spite of the fact that some of the soldiers may be very tall and others very short. The difference is that the common purpose and controlling discipline of a military unit does not yet exist in the EMS. Fixed exchange rates require that the member countries maintain uniform rates of economic growth, inflation, interest rates and external balances.

Although there is some room for variances in any one of these interrelated economic factors by compensating in another one, the structure of the system does not allow for wide variations over an extended period of time. Since purchasing power is the ultimate criterion for exchange rate relationships, purchasing power parity eventually will determine exchange rates, and this requires a convergence or, at least, a fixed relationship between economic policies and performance of the member countries.

Internal Stresses...

Since the inception of the EMS, there have been wide variations in the economic performance of the member countries. The following table illustrates these discrepancies based on the available data for 1980:

ECONOMIC PERFORMANCE IN 1980

Country	Real GNP Growth (%)	Consumer Prices (% Yr/Yr)	Current Account Balance ($ billions)
Belg./Lux.	1.0 (est.)	6.7	– 4.7 (IIIQ, 1980)
Denmark	– 0.7	12.3	– 2.5
France	1.2	13.3	– 7.3
Germany	1.8	5.5	– 15.8
Ireland	1.0	18.2	– 1.2
Netherlands	1.2	6.5	– 2.4
Italy	4.0	21.2	– 9.9

How does divergence in economic performance affect exchange rates? Inflation diminishes purchasing power and the real return on investment. Investment then flows toward countries with lower rates of inflation where the "real" return (interest rates minus the rate of inflation) is greater. This simultaneously creates a demand for the currency of the country with lower inflation and reduces demand for the more inflated currency. In order to reverse these financial flows, interest rates are raised to the point where the real interest rate is equal to or greater than those in the country with the lower inflation rate. This may in turn create a competitive interest rate race. As real interest rates rise, economic growth tends to decline.

Inflation also affects trade. As a country's domestic inflation increases, imports are temporarily cheaper (until exchange rates adjust), stimulating the purchase of imported goods. The demand for foreign currency increases to pay for these imports and the supply of the purchaser's currency on the exchange market increases and thus cheapens. This, too, leads to a divergence of exchange rates. Since a current account deficit represents the difference between a nation's exports and imports of goods and services, such a deficit also represents the net outflow of trade related funds. A current account deficit increases the supply of funds in the foreign exchange market. All of these factors tend to cause the exchange rates between countries with differing economic performance to diverge. It is apparent, then, from a consideration of the table that pressures toward divergence are already great and will increase if the divergence in economic performance increases.

This would appear to argue for a greater uniformity of economic policies if the members of the EMS wish it to remain intact. But differing political, economic and social goals generate differing policy responses. In one country, controlling inflation may take priority over reducing unemployment. In another, exports may play a greater role in economic activity. Elsewhere a comprehensive and pervasive social welfare system may divert financial resources to the state, creating budget deficits which raise inflation and interest rates.

...And External Strains

Not all of the stresses on the EMS are internal. The originators of the system had hoped that by creating a zone of monetary stability they would insulate their currencies from the effects of external volatility and instability introduced by other currencies, particularly the dollar. In fact, the influence of the dollar has been magnified in some respects. Since the currencies of the EMS member countries are tied together in a matrix of more or less rigid parities a strong appreciation or depreciation of any one of these currencies against the dollar pulls the others along with it without regard for the bilateral economic relationships of each country with the U.S.

The larger the economy which is moving against the dollar, the more irresistible the pressure. Since the West German economy is the largest and the strongest in the EMS, if economic trends in that country move differently than in the U.S., causing the DM to fall or rise against the dollar, the impact on other

members is enormous. In 1979, as the German mark gained strength against the dollar, the other EMS countries also found their currencies strengthening against the dollar, too, in spite of the fact that in many cases this priced their exports out of U.S. (and other dollar denominated) markets, and encouraged imports causing their trade and current accounts to go into deficit. At the same time, since the bulk of their trade was with other EMS countries, they were deriving no particular compensatory trade advantages since the parities among them remained roughly the same. Some benefit was derived, however, because oil imports, paid for in dollars, became cheaper.

Conversely, as the DM has weakened against the dollar, EMS exchange rates have been pulled down, increasing the cost of dollar denominated imports. To the degree that an EMS country's trade is transacted in non-EMS currencies, particularly the dollar, there will be pressure on its exchange rate to diverge from its EMS parities. These pressures on the system have been recognized and mechanisms have been developed to deal with them. But they are largely short term, buying time for longer-term adjustment through a convergence of economic policies. Although the shorter-term adjustment features of the EMS have worked in the past and continue to work, there has been virtually no progress toward unified economic policies.

The short-term adjustment mechanism is intervention in the foreign exchange market by any EMS member country whose exchange rate threatens to move outside of the permitted limits from the central parity rate with another EMS currency. That country must either buy or sell in the market to restore equilibrium. If, for example, the DM strengthens against the Belgian franc, the German central bank will sell DMs and buy francs until the balance is restored. At times of great stress in the system, the amounts involved in such intervention have been huge. Further, intervention can not be isolated from its effects on domestic money supply. Large scale intervention introduces severe distortions into domestic monetary policies. The response to these sudden jumps in money supply is frequently a tightening of credit availability to reduce the inflationary impact. Thus, intervention transfers instability from exchange rates to interest rates.

Two years is too short a time to come to a firm conclusion about the long-term viability of the EMS. It has survived remarkable stresses and strains in that time. Recently, European currencies have plunged against the dollar. Italy and Germany are in recession while interest rates in the United States have drained funds from Europe and diminished the value of their financial assets. The burden of sustaining the EMS falls most heavily on the larger economies, particularly the German and French. How long will it be in their interest to maintain it? The EMS was the brainchild of President Giscard d'Estaing and Chancellor Schmidt. One is now leaving the scene, and the other presides over a troubled economy deeply riven by political and economic conflicts.

Commitment to the EMS may weaken if it conflicts with domestic demands. In spite of adherence to the principles of the EMS, each member country is, in the last analysis, governed by what it perceives to be in its own best interest at any given time. But, it is less a question of whether the EMS will survive than how it will maintain the zone of relative monetary stability to which it is dedicated. Finally, the goal of unifying the disparate economic policies of the EMS nations remains as far from realization today as it was at the system's inception.

—William L. K. Schwarz, Vice President

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JUNE 1981

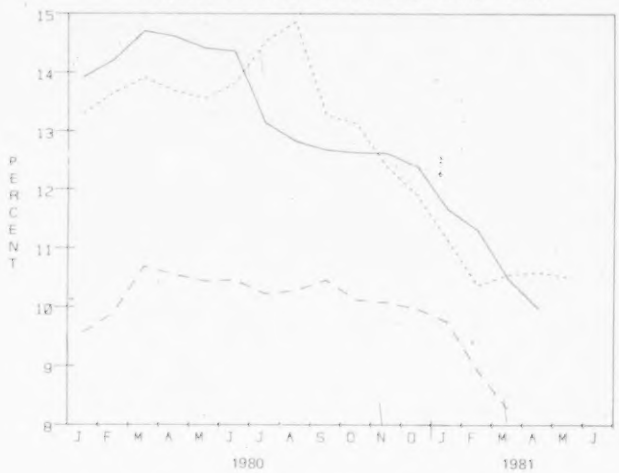
The Meaning Of Less Inflation

This may surprise you, but for all the rhetoric you hear these days about the need to reduce the rate of inflation, we have already done so—and to a significant extent. No matter which index you look at—consumer price index (CPI), producer price index (PPI), personal consumption expenditures index (PCE), or the various indexes of basic commodities' prices, inflation has cooled considerably from the overheated pace of early 1980. What is more, since virtually none of this improvement can be ascribed to any act of the Reagan Administration, it is very likely that further progress is in store, since reducing inflation is plainly Washington's number one priority.

The notion then comes to mind that this curbing of inflation could result in some rather interesting side effects. Because of the high rate of inflation that we in the United States have experienced in recent years, many businesses, households and individuals have made decisions in the belief that inflation would continue. Some have come to this conclusion involuntarily, figuring that there was no use in fighting higher prices. Others, seeing their incomes rise with inflation, have been less unwilling to accept it. Still others have learned to benefit from inflation; these people look forward to its continuation. Whatever the case, the slowing of inflation that has already occurred—not to mention what lies ahead—calls for a reexamination of many people's beliefs, buying habits, investment and business decisions.

As you can see from the chart, the rate of inflation has slowed dramatically since the beginning of 1980. The PCE index is up 8.3 per cent compared with nearly 11 per cent in the twelve months ending March 1980. For its part, the CPI has risen by about 10 per cent in the last twelve months, down from 15 per cent in the year ending March 1980. And the PPI's twelve month percentage change is 10½ per cent, down from 14 per cent in March a year ago. None of this slowing is due to anything that the President can take credit for,

12 MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX (LINE), PRODUCER PRICE INDEX (DOT), PCE DEFLATOR (DASH)



since the Reagan Administration has been in office about five months and any policies enacted to slow inflation clearly require a longer period of time to have a positive impact. (Ironically, the President has managed to influence prices *negatively* by releasing gasoline and oil prices from domestic controls, thus causing them to jump earlier this year. But to the extent that higher prices have encouraged conservation, they may yet prove to be a positive factor by keeping usage so far below production that prices will soon come down.)

Many Have Accepted Inflation . . .

Those who have accepted inflation involuntarily will have no problem with its slowing. In actual fact, no one *likes* to pay more for something, [illegible]se of us who look only at this aspect of inflatio[illegible] not be disappointed by its departure. However, a number of people have begun to accept inflation as a way of life.

You don't have to look far to find people who have accepted inflation. The first group that comes to mind is those whose incomes are linked formally to the consumer price index. Known as indexing, this is a system by which wages, pensions, welfare benefits and other types of income are adjusted automatically for inflation—usually as measured by the consumer price

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index. Thus, as the CPI advances, so does the income linked to it. Since the CPI is generally acknowledged to overstate inflation, actual buying power of those whose incomes are linked to the CPI has risen. Among the largest and best known groups of recipients of indexed income are those on Social Security. Last July, Social Security recipients received a 14.3 per cent increase in their benefits based on a similar rise in the CPI some months earlier. Besides Social Security beneficiaries, retired government workers' pensions are indexed to the CPI, as are those of persons receiving food stamps and disability payments. Indeed, according to the 1981 budget estimates, 42 per cent of all government outlays will go to programs whose benefits are indexed.

Of course, indexing is widespread in the private sector. Indeed, it was a union in the private sector, the United Auto Workers, which in 1948 negotiated the first labor contract that included a cost-of-living adjustment (COLA). COLA clauses were slow to catch on, but by 1965 an estimated 26 per cent of unionized employees were covered by such agreements; the percentage has climbed to nearly 60 per cent today. Ironically, now that inflation is abating, those COLA clauses will help to slow it further, since they will call for smaller increments, thus holding down costs in both the public and private sectors. Non-union workers have kept up with inflation, too. Either because of the COLA clauses that union workers receive, or because of the general awareness of inflation, those who don't get automatic adjustments in pay tend to receive pay raises linked to inflation on an informal basis. I would bet, for example, that most white-collar workers have received a cost-of-living adjustment in their salaries over the past year or two —whether it was called that or not.

. . . Some Need It . . .

As large as this group sounds, it is only the tip of the iceberg, when it comes to people who have learned to live with inflation. Having looked at labor, let us examine management. Inflation has helped management in many ways. For one thing, it allows businessmen to raise their prices without losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are stable. Naturally, inflation boosts the dollar value of sales and earnings thus making many a manager look good—at least on the surface.

Many contracts are signed in the expectation that inflation will benefit one party or the other. Either the terms of the contract are adjusted upward in conjunction with whatever increase occurs in the consumer price index or the spread between the cost of materials in the finished product can be expected to widen as the price level in general goes up. Many businessmen look to inflation as a cushion, in that they can pass along increases in costs more readily in an inflationary environment than in an era of price stability.

Certainly the real estate market has come to terms with inflation. Landlords have long since inserted COLA clauses in leases, while a great many people have bought properties with only the smallest of down payments and the longest of mortgages that can be obtained, thus becoming highly leveraged. Plainly, these people are counting on inflation to continue, so that the increase in prices and incomes will ensure that they will be able to pay off their mortgages with cheaper dollars. A growing number of individuals have become involved in real estate, buying not just one house to live in, but additional houses and apartments in the belief that real estate is an unbeatable investment whose value will not only keep up with inflation —but exceed it.

Because mortgage rates got so high that many people could not even buy their first house, a number of lending institutions have developed new ways of helping people finance the purchase of a home. Taking their cue from the equity-kicker concept used in commercial real estate and corporate finance, some savings and loan associations have developed a concept known as shared-appreciation mortgages (SAMs). These recently became sanctioned by the Federal Home Loan Bank Board, which regulates Federally chartered and insured S & Ls. These equity-participation mortgage loans permit the homebuyer to obtain a below-market interest rate, in return for which the lender collects a share of the home's appreciation after a stated number of years, or when the mortgage is paid off through sale of the property.

Borrowers in general have not only learned to accept inflation, many even like it as well. In a period of inflation, borrowers come out ahead for several reasons. The first is that the loan is paid back with cheaper dollars—the longer the term of the loan the cheaper the dollars so long as inflation continues to erode the buying power of the buck. For another, since borrowing permits one to buy something sooner than would otherwise be the case had one waited until one saved enough money to afford the purchase, one is ahead in a period of inflation because buying sooner rather than later beats higher prices. Finally, a borrower can deduct the interest cost of obtaining the loan from one's tax return, thereby reducing taxable income.

It may surprise you to learn that lenders have a stake in inflation, too. For one thing, inflation has bailed out many a bad loan—especially in the real estate area. Indeed, continuing inflation makes it easier for borrowers to obtain the funds to repay their loans, thus helping many a lending officer sleep better at night. (Of course, if lending officers were to consider the buying power of the dollars they were getting back, they might have a nightmare or two.) To protect them-

selves from the negative aspects of inflation, lenders have been making loans with interest rates that float. Long a factor in the market for short-term loans, variable rates have recently become common in the longer-term markets. Last November, a major finance company sold to the public $250 million worth of ten-year debt with an adjustable interest rate tied to the rate on ten-year Treasury securities. Several insurance companies have begun asking floating rates on the funds they deploy for even longer periods.

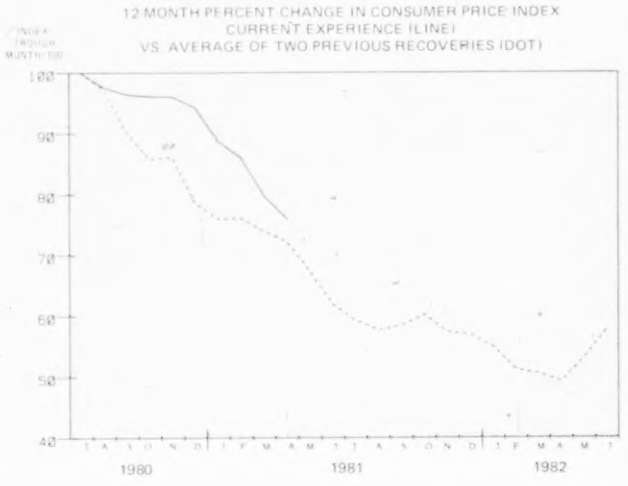
In the short-term market, where floating rate loans have been common for some time, the rate that borrowers pay is linked to either the banks' prime rate, or a money-market rate. Since inflation raises the banks' non-interest operating costs, they must lend increased numbers of dollars, if they are to spread these rising operating costs over a larger volume. Thus even the banks are not disinterested in inflation. Apparently, people are no longer heeding the warning in Hamlet: "Neither a borrower nor a lender be."

If borrowers and lenders have learned to live with inflation, what about savers? No problem here; they have adjusted to inflation, too. Because of inflation, high interest rates are available for savers through the purchase of such money market instruments as Treasury bills, certificates of deposit, and more recently, money market mutual funds. Thus while inflation may erode some peoples' savings, others at the same time have been able to enjoy the fruits of inflation in the form of much higher interest rates than they otherwise could get. Then there are those who collect commodities of one sort or another. By these I mean stamps, antiques, jewelry, works of art, ceramics, Persian rugs, and so forth. I wonder how many of these collectors bought these objects for their beauty alone as opposed to what they think their worth will be in months and years to come. And if these collectibles were purchased with borrowed funds, their buyers would have an even greater stake in seeing inflation continue for reasons I have already noted.

One group with an interest in inflation is our elected officials. Under inflation, politicians can make more promises than they know will be kept in real terms. This is because they can promise to spend certain amounts of dollars on various projects, benefits etc., knowing that by the time they are spent, these dollars will not buy what their constituents think they will. In addition, thanks to our "progressive" tax structure, inflation pushes people into higher tax brackets, increasing the revenues that Washington (and some states) gets from income taxes. This, too, benefits politicians, for it gives them more money to spend. On the local scene, politicians benefit additionally from inflation because higher prices on goods and services mean more sales taxes will be collected without there necessarily being an expansion in the real volume of transactions.

. . . But New Strategies Are Called For

The message is clear. Since inflation has already wound down to a considerable extent and should retreat even further over the coming year, if only because of the normal improvement in inflation in the two years or so following the end of a recession (see chart), not to mention the determination of the Reagan Administration to bring inflation lower, people would be wise to start adjusting to these new "facts of life." Those who bet on continued high rates of inflation will lose, while those who are counting on greater price stability will come out ahead. For example, workers who demand big wage increases in the expectation that their employers can pass along the higher cost may well find themselves without work. By the same token, those employers who blithely accept higher wage (and other) costs with the same belief may find that they are unable to pass them along because less inflation is the order of the day and their price increases will stand out more.



People had better be cautious, when it comes to the purchase or sale of real estate. Too much leverage might not be advisable in an era of less inflation, as far as borrowers are concerned. Lenders should scrutinize the loans they make more carefully, and those who give up some immediate returns for the promise of future returns linked to inflation may be equally as disappointed. COLA clauses may prove less rewarding. As inflation continues to recede, those investors who do not lock in today's high interest rates could well be missing what will be a golden opportunity, since less inflation usually means lower interest rates.

Since virtually everyone will be affected by the reduced inflation environment, it would seem wise to adjust now rather than later. In so doing you will minimize the consequences of the return to price stability, while at the same time you might be able to take advantage of some of the distortions that still prevail as a legacy from the high inflation environment of the past.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JULY 1981

Quarterly Business Conditions Analysis

The drop in economic activity in the second quarter has produced fears that the economy may have entered into a new recession. This is particularly ironic because the umpire of the business cycle, the National Bureau of Economic Research (NBER), has just decided that the 1980 recession came to an end last July and was the shortest on record. If the GNP continues to fall, the recovery that the Bureau says got under way in August, 1980 could also turn out to have been the shortest on record.

This apparent telescoping of the business cycle raises some questions. According to the NBER, the 1980 recession was only half as long as the one-year average recession of the postwar era. And if the ensuing recovery lasted also about six months, it would not only be the shortest on record—but less than one-sixth the length of the average postwar peacetime expansion. Indeed, you would have to go back to the expansion of 1912-1913 before finding anything remotely as short as six months—and that one lasted one year.

Are The Recession Dates Wrong?

At this time, I would like to propose that the NBER reconsider the starting and ending dates for the 1980 recession. To many consumers and businessmen in the "real world," the recession really got under way in 1979—and is still with us. While the real gross national product did advance in 1979, practically all of the rise occurred in that year's first quarter. The real GNP rose 3.2 per cent in 1979 over 1978—but the first quarter's rate alone was three per cent higher than 1978. The real GNP virtually flattened after that—not at all dissimilar to the flatness that characterized 1974, which the NBER counted as part of the 1973-75 recession.

As for changing the terminal date, I would observe that, in spite of first-quarter 1981's 8½ per cent jump in the real GNP, the economy today has risen at an annual rate of only one per cent since the beginning of 1979. By contrast, in the preceding nine quarters, the GNP grew at a four per cent clip. This kind of performance is unlikely to change any time soon. The reason for today's softness in economic activity may be different from the past, but the end result is the same. Strikes, bad weather, reduced energy supplies, soaring inflation, speculation and credit controls have now been replaced by tight money and high real interest rates which are unlikely to abate any time soon. As a result, the economy is likely to perform below par for several more quarters at the very least, as a growing number of industries experience sales and output declines with consequent squeezes on earnings and drops in employment.

Several observers have made the point that the U.S. economy has become highly segmented. That is—it no longer moves as a monolith, with all industries expanding during good times and contracting during bad times. Rather, it has split into different sectors, some immune to the effects of the business cycle while others seem unable to escape it.

Looking beneath the surface, this seems to make a lot of sense. Such key industries as automobiles and housing have long evidenced a sensitivity to changes in business and financial conditions. That is—they would be among the first to decline when interest rates rose and money tightened sending the economy into a downturn, but would revive with equal vigor when these conditions reversed. In the last two years, however, both autos and housing have been severely depressed. After averaging 9.2 million units in 1977 and 1978, sales of new domestic passenger cars fell to 8.3 million units in 1979—then plunged to 6.6 million units in 1980. The selling rate so far this year is 6.5 million units. However, sales have weakened in recent months; second-quarter new-car sales amounted to an annual rate of 5.6 million units. And in

NO REPORT IN AUGUST

The monthly economic report will not be published during August. The next issue will appear in September.

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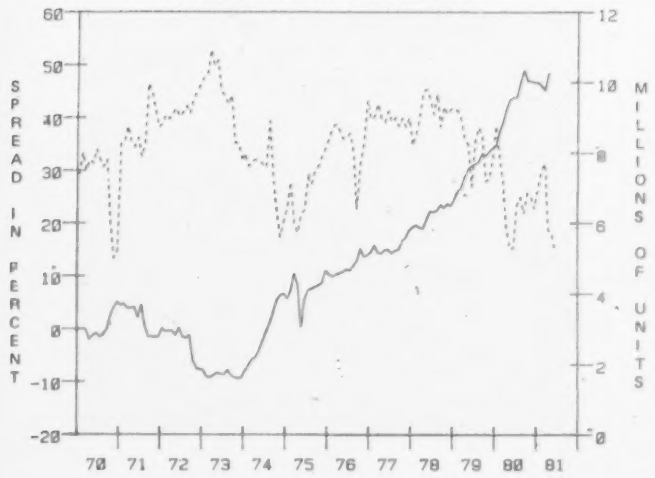
the last ten days of June and the first ten days of July the selling rate slumped to 4.8 million units. With the exception of the General Motors strike in fourth-quarter 1970, this was the lowest selling rate for new domestic-model automobiles for any 20-day period in at least two decades.

Unquestionably, high interest rates have played a part in the auto industry's slump. Not only have dealers been reluctant to stock cars with interest rates adding so much to their costs, but consumers have been reluctant to buy for the same reason. Autos also have been hurt by their rapid run-up in prices. As you can see from the chart, new-car prices have gone up much faster than buying power in recent years, and this clearly has had a negative impact on sales.

SPREAD BETWEEN RISE IN NEW CAR PRICES AND GROWTH IN REAL PER CAPITA DISPOSABLE INCOME (LINE) SINCE JAN. 1970 VS. NEW DOMESTIC CAR SALES (DOT)



For housing, whose prices also have outpaced incomes, it appears to be more a question of availability and price of money than cost of the home. This is because, in contrast to automobiles and most other goods, prices of used or existing homes have gone *up* over the years, thereby overcoming the deterrent of higher new-home purchase prices. That is to say—people look upon the purchase of a home as an investment, one whose value has kept up with, if not exceeded the overall rate of inflation. Still, new-home construction has slumped. After averaging two million units in 1977 and 1978, new private housing starts dropped 13 per cent to 1.7 million units in 1979—then tumbled another 26 per cent to 1.3 million units in 1980. They have been bumping along at this rate so far in 1981.

Not surprisingly, the prolonged slump in autos and housing has affected a number of industries whose fortunes are tied to them. Steel output has dropped by about seven per cent since last November, production of rubber tires is no higher than it was almost two years ago, while output of building materials and household goods is down by nine per cent and five per cent respectively over the past two years. Since production of automobiles and the materials that go into them tends to be concentrated in the North central part of the United States, the economies of such states as Michigan, Ohio and Pennsylvania have been more affected than the national average. This is also having a rippling effect on a growing number of industries, since many suppliers tend to be small businesses who are not only affected by autos and housing, but also by the effect high interest rates have on their own financing costs.

Pluses And Minuses.

It was the minuses outweighing the pluses that caused the real GNP to drop in the second quarter. One of the pluses is defense. Although output of defense and space equipment has barely returned to 1967 levels, the increase over the past 3½ years has been substantial. In real terms, after adjusting for inflation, production of defense and space equipment has risen at an average annual rate of about 7½ per cent. Even faster growth seems likely, in view of the sharp jump in unfilled orders for defense products, prime contract awards—not to mention the Reagan Administration's determination to boost defense outlays even faster.

Another sector that seems to be strong is energy. Although energy output has declined over the past year, this largely has been due to the combination of last year's decline in the economy and conservation of petroleum-based energy in reaction to earlier jumps in oil prices. But the energy industry also consists of those firms that are involved in the finding, processing, distribution and improved efficiency of energy and this sector is growing very nicely. This latter group could be expanded to include technology in general. Thus producers of computers, controls and instruments of various types as reporting nice gains in sales and earnings, as businessmen try to cope with the high cost of energy by using it more efficiently and by substituting telecommunications for the physical movement of people.

Exports are helping—so far. As the table on the back shows, net exports as measured in the GNP accounts remain in comfortable surplus. This reflects the earlier weakness of the dollar and the earlier booms in overseas economies—both of which have since disappeared. Also mixed in nature are the capital goods industries. Production of business equipment in the past half year has gone up more than three times as fast as total output, but new orders for nondefense capital goods have fallen 3½ per cent between January and May of this year, suggesting some hesitation about the future.

I am looking for more negatives than positives over the next few months. This is because I believe that the interest-sensitive industries will continue to be weaker than the non-interest sensitive sectors will be strong. In today's context, I would ascribe this to the kind of economic policy that is being administered by Washington. The government continues to be a significant drainer of funds from the money and capital markets. Washington's on-and-off budget financing is likely to total $135 billion in this fiscal year compared with $119 billion in fiscal year 1980. At the same time the Federal Reserve is committed to keeping the growth of money and credit aggregates to an annual rate far below the likely rate of rise of nominal GNP. Since the government gets first crack at the pool of funds available for borrowing, the private sector has to scramble for the rest, and those that are most sensitive to higher interest rates or have relatively difficult access to money are those that will suffer.

Although the combination of a loose fiscal policy and a tight monetary policy will prevent the private sector from mounting a healthy recovery, any declines that surface in the aggregate data should be relatively small. For one thing, I don't anticipate any form of artificial credit constraint in the marketplace. Recent steep declines in economic activity have traced in one way or another to what has come to be known as a "credit crunch," where money is suddenly unavailable regardless of its price.

Last year's steep drop in the economy was due to just such a development. The Federal Reserve's credit controls of last year were largely interpreted to mean that credit was not available for most consumers and businessmen. This led to a sudden drop in credit usage and a concomitant decline in sales of those products heavily dependent on credit. The previous business cycle, in 1973-1975, also traced in part to a credit squeeze as banks were pressured by Washington to charge less for loans than it was costing them to raise funds in the money markets. Quite naturally, many banks became reluctant to make new loans under these circumstances. The 1970 recession traced to a sudden disappearance of individuals and companies willing to invest in corporate commercial paper, producing crunch-like effects as well. And, of course, who can forget the first modern credit crunch that took place in 1966? Then, interest rates moved above the ceilings that banks were allowed to pay for certificates of deposit thus depriving them of funds to lend to their customers.

Besides the absence of a credit crunch, consumers continue to be in good shape financially. The misinterpretation of last year's credit controls caused a cutback in consumers' use of credit, which many have not restored to this day. This not only goes for installment debt, but for mortgage debt as well. Speaking of mortgage debt, there is the increased value of homes that people can monetize. And while total employment dropped a bit in June, the employment-population ratio remains at 59 per cent, only slightly below the all-time record set in 1979. With so many people at work, it follows that incomes are continuing to rise. The fact that inflation has already slowed to the single-digit zone and is likely to decelerate further will help boost buying power in the months ahead.

Another argument in favor of a mild decline is the state of business inventories. Even though there was a jump in stockpiling in the second quarter, businessmen have kept a close watch on inventories for the last couple of years. This is not surprising when you consider the repeated warnings of recession emanating from their economists and, more recently, the high interest rates which have made stockpiling extremely expensive. Whether you look at them in current dollars or in real terms, inventories relative to sales remain well below year-ago levels. That being the case, any further softening of sales would require a smaller adjustment in production than might have been the case had inventories been high. Finally, those sectors of the economy that are still strong are likely to continue so, since they are either less sensitive to the availability of money and its cost, or are responding to longer-run, non-cyclical considerations.

The Outlook Is Bleak.

Before you become too sanguine over the situation, remember that this kind of zigzag economy that we have experienced since early 1979 could very well continue beyond yearend. That is—we might be subject to one or two quarters' worth of growth followed by one or two quarters' worth of stagnation or economic decline for the next few years. To become complacent about this situation is to write off autos, housing and other similarly-affected industries —something I know we are not prepared to do. Yet the alternative is not for the Federal Reserve to loosen credit in order to bring interest rates down and make funds more available for the purchase of these key hardgoods. This is because such a development would only be temporary and would be followed by even higher rates of interest as inflation psychology reached a new higher level. Rather, the alternative must be a tightening of fiscal policy.

The Reagan Administration must examine its spending and taxing policies very carefully with the aim of bringing down the budget deficit as soon as possible so that Washington will not continue to drain strength from the private sector through its huge financing requirements. The financial community does not doubt the Administration's intentions to do so: It only questions whether this can be achieved by boosting defense spending and cutting taxes while barely holding the line on nondefense outlays. H

July, 1981
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< ACTUAL				PROJECTED >							
	1980		YEAR 1980		1981				YEAR 1981		1982	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2637.3	2730.6	**2626.1**	**8.8**	2853.0	2881.0	2927.0	2999.4	**2915.1**	**11.0**	3066.0	3146.8
GNP: $72	1471.9	1485.6	**1480.7**	**−0.2**	1516.4	1509.1	1508.6	1517.1	**1512.8**	**2.2**	1522.3	1535.9
% Change, Annual Rates	2.4	3.8	**−0.2**		8.6	−1.9	−0.1	2.3	**2.2**		1.4	3.6
Consumption	1682.2	1751.0	**1672.7**	**10.7**	1810.1	1830.3	1871.1	1917.7	**1857.3**	**11.0**	1963.4	2017.4
Durables	208.8	223.3	**211.9**	**−0.2**	238.3	226.7	233.2	245.7	**236.0**	**11.4**	250.3	262.2
Non-Durables	674.2	703.5	**675.7**	**12.2**	726.0	732.7	744.0	759.1	**740.4**	**9.6**	773.4	789.4
Services	799.2	824.2	**785.2**	**12.8**	845.8	870.9	893.8	912.9	**880.9**	**12.2**	939.6	965.8
Investment	377.1	397.7	**395.3**	**−4.9**	437.1	453.8	439.2	451.6	**445.4**	**12.7**	464.7	480.1
Non-Residential	294.0	302.1	**295.9**	**5.8**	315.9	322.0	324.9	332.0	**323.7**	**9.4**	341.8	344.1
Producers Durable Equipment	186.8	190.7	**187.1**	**2.0**	198.7	201.1	203.7	207.8	**202.8**	**8.4**	212.8	214.9
Structures	107.3	111.5	**108.8**	**13.0**	117.2	120.9	121.2	124.1	**120.9**	**11.1**	129.0	129.2
Residential	99.2	113.0	**105.3**	**−11.2**	116.7	111.4	107.2	104.8	**110.0**	**4.5**	112.9	123.1
Inventory Changes	−16.0	−17.4	**−5.9**		4.5	20.4	7.1	14.8	**11.7**		10.0	12.8
Net Exports	44.5	23.3	**23.3**		29.2	19.4	24.7	22.6	**24.0**		17.2	16.0
Government Purchases	533.5	558.6	**534.7**	**12.9**	576.5	577.6	592.0	607.6	**588.4**	**10.0**	620.7	633.3
Federal Defense	131.4	141.6	**131.7**	**18.4**	145.2	148.1	155.2	164.5	**153.3**	**16.4**	169.0	173.0
Federal Civilian	63.5	70.4	**67.2**	**18.5**	76.4	71.4	70.7	70.5	**72.3**	**7.5**	71.6	72.9
State & Local	338.6	346.6	**335.8**	**9.8**	354.9	358.1	366.1	372.6	**362.9**	**8.1**	380.1	387.4
Final Sales: $72	1476.9	1492.7	**1483.6**	**0.7**	1517.8	1499.4	1505.5	1510.6	**1508.3**	**1.7**	1518.1	1530.6
% Change, Annual Rates	4.1	4.3	**0.7**		6.9	−4.8	1.6	1.4	**1.7**		2.0	3.3
GNP Price Index (1972 = 100)	179.2	183.8	**177.4**	**9.0**	188.1	190.9	194.0	197.7	**192.7**	**8.6**	201.4	204.9
% Change, Annual Rates	9.2	10.7	**9.0**		9.8	6.0	6.7	7.8	**8.6**		7.7	7.1
PCE Deflator (1972 = 100)	180.7	184.9	**178.9**	**10.2**	188.5	191.5	194.2	197.4	**192.9**	**7.8**	201.2	204.6
% Change, Annual Rates	8.8	9.6	**10.2**		8.0	6.5	5.7	6.8	**7.8**		8.0	6.9
Consumer Price Index (1967 = 100)	249.2	256.9	**247.0**	**13.5**	263.6	268.4	273.7	278.3	**271.0**	**9.7**	282.8	287.9
% Change, Annual Rates	7.8	12.9	**13.5**		10.8	7.5	8.0	6.9	**9.7**		6.7	7.3
Total Personal Income	2182.1	2256.4	**2160.3**	**11.1**	2319.7	2367.8	2413.4	2464.0	**2391.2**	**10.7**	2517.8	2572.9
Disposable Personal Income	1840.6	1897.0	**1821.7**	**11.0**	1947.8	1985.4	2024.3	2078.2	**2008.9**	**10.3**	2122.2	2164.7
Savings Rate	6.1	5.1	**5.6**		4.6	5.3	5.1	5.3	**5.1**		5.0	4.3
Employment Rate	57.5	57.4	**57.7**		57.7	58.0	58.0	58.0	**57.9**		58.2	58.3
Unemployment Rate	7.5	7.5	**7.1**		7.3	7.4	7.6	7.7	**7.5**		7.5	7.4
Indus. Production (1967 = 100)	142.1	149.1	**147.1**	**−3.6**	151.8	152.6	151.7	153.6	**152.4**	**3.6**	154.7	155.9
Housing Starts (000)	1390.0	1534.7	**1303.5**	**−24.0**	1390.7	1174.3	1008.6	1163.0	**1184.1**	**−9.2**	1238.8	1429.8
Domestic Auto Sales (000)	6497.0	6668.3	**6643.9**	**−19.3**	7400.0	5566.7	6000.5	6922.2	**6472.4**	**−2.6**	7043.6	6477.3
Corporate Pre-Tax Profits	237.6	249.5	**245.5**	**−3.8**	259.1	229.9	209.8	221.5	**230.1**	**−6.3**	221.8	231.5
− Taxes	78.5	85.2	**82.4**	**−6.0**	91.1	78.9	69.3	73.8	**78.3**	**−4.9**	73.7	77.6
Net Profits	159.1	164.3	**163.2**	**−2.7**	168.0	151.0	140.5	147.7	**151.8**	**−7.0**	148.1	153.9
− Dividend Payments	56.7	57.7	**56.0**	**11.7**	59.6	62.0	63.9	65.9	**62.8**	**12.2**	67.7	69.5
Undistributed Profits	102.4	106.6	**107.2**	**−8.9**	108.4	89.0	76.6	81.8	**88.9**	**−17.0**	80.4	84.3
+ Depreciation	160.5	165.4	**158.3**	**13.4**	170.6	175.6	199.3	204.0	**187.4**	**18.4**	211.5	216.7
− Inventory Profits	41.7	48.4	**45.6**	**7.1**	39.2	24.1	22.3	28.7	**28.6**	**−37.4**	33.3	33.2
Net Cash Flow	221.2	223.6	**219.8**	**2.4**	239.8	240.5	253.6	257.2	**247.8**	**12.8**	258.6	267.9

85350-3

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

SEPTEMBER 1981

Breaking The Gridlock

A gridlock has developed in the financial markets which is not only feeding on itself, but is beginning to affect a growing portion of the U.S. economy. Persistently high interest rates are taking their toll in both the financial and nonfinancial sectors, raising the possibility that the U.S. economy might not break out of its 2½-year period of stagnation anytime soon. Indeed, if there is a breakout, it could very well be on the downside, with business tumbling into another recession.

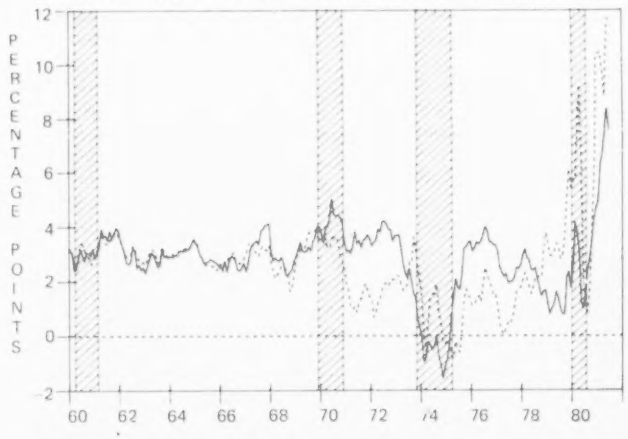
The Fundamentals Suggest Lower Rates . . .

The economic fundamentals certainly would have called for interest rates to decline many months ago. For one thing, the rate of inflation—a key determinant of interest rates—has moderated significantly over the past year. The rate of rise of the consumer price index has slowed from 18 per cent in the first quarter of 1980, to nine per cent since February. Similar slowings have occurred in the personal consumption expenditures deflator and the producer price index. And as you can see from Chart I, until last year, there used to be a pretty close and consistent relationship between inflation and interest rates—both short-term and long-term.

Another economic fundamental that in the past would have produced lower interest rates is economic slack. Not only did the gross national product adjusted for inflation decline in the second calendar quarter of this year, it fell in the second quarter of each of the two previous years, producing a rather lengthy period of relatively little growth. In the past, such reductions in economic activity led to lower interest rates because of the reduced demand for funds as well as the slower rate of inflation noted above.

Even by the monetarist way of looking at things—where the money supply is all-important—interest rates should be down. The money supply MI-B is growing very slowly so far this year. Its year-to-date growth of 4½ per cent has fallen well below the Federal Reserve's minimum objective of six per cent per year

CHART I
SPREAD BETWEEN AA UTILITY RATE AND INFLATION RATE (LINE) AND SPREAD BETWEEN PRIME RATE AND INFLATION RATE (DOT)



between fourth-quarter 1980 and fourth-quarter 1981 (see Chart III, Page 3). In the past, this would lead the markets to anticipate lower interest rates because they would expect the Federal Reserve to be more generous in providing reserves to the banking system in order to boost money growth.

Speaking of the financial markets, the script called for them to be cheered by passage of the President's economic program. Indeed, according to the "rational expectations" faction in Washington, just the very passage of the President's program was supposed to, in and of itself, produce lower interest rates and a rising stock market—prerequisites to help revitalize the U.S. economy. After all, the Administration's program contains the four items that the financial community has longed for the most: lower taxes, a slimmer budget, less inflation and reduced regulations.

. . . But Rates Have Refused To Fall . . .

In spite of these rather powerful forces, interest rates have remained high. Some of the reasons have been widely mentioned, but some have not, so let me review the causes as I see them. First and foremost, of course, there is widespread skepticism over the shape of the Federal budget. The deficit in the fiscal year drawing to a close is a good example of the

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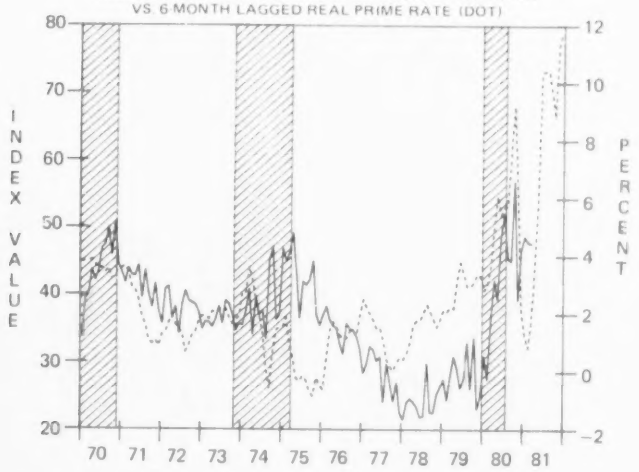
markets' view toward Presidential promises and Congressional actions.

Originally promised by Jimmy Carter to be in balance, the fiscal 1981 budget was subsequently projected by the House-Senate Conference Committee last autumn to be in deficit by $27½ billion. This was soon revised upward to $55½ billion by the Reagan Administration, and to $58 billion by the Congress. But with ten months' data already in, the fiscal year-to-date red ink total already amounts to almost $60 billion. This same upward revision process appears to have affected the budget deficit for fiscal year 1982, while the amount of red ink currently projected for fiscal '83 and beyond also is being revised upward to the point where a balanced budget even by fiscal year 1984 no longer looks likely.

CHART II
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE)
VS. 6-MONTH LAGGED REAL PRIME RATE (DOT)



The markets are fully aware of the President's determination to balance the budget in order to bring down inflation. However, in view of past history, the markets apparently want to see actual reductions in Federal expenditures and not just promises. To make matters worse, while past Administrations have tended to underestimate spending—there is a good possibility that the Reagan Administration is overestimating revenues, too. Besides the immediate revenue losses that will result from the Administration's economic program, there is the indexing provision scheduled to begin in 1985. Ostensibly passed to protect individuals from the higher taxes that result from inflation pushing them into higher brackets, indexing also deprives the Treasury of billions of dollars in revenues, in effect cutting taxes continually without cutting spending at the same time.

Plainly, the Federal Reserve is playing a key role in keeping interest rates high. By concentrating on the monetary aggregates instead of on financial market conditions, the Fed has made interest rates more unstable than they used to be. This instability, which has caused financial market participants to demand higher rates of return because of the uncertainties associated with monetary policy, its effects on the economy and on the rate of inflation, began in autumn 1979, shortly after the Federal Reserve switched to serious monetarism. Since that time, the month-to-month movement in the key Federal funds rate has averaged approximately seven times the size of the average monthly change in this rate during the previous two years. And ironically, the money supply appears to have grown less smoothly during this time as well.

As a result of the protracted high level of interest rates, a number of Catch 22s have developed which tend to keep interest rates high. For example, high interest rates hurt economic growth and yield less tax revenues for Washington. At the same time, high interest rates boost government spending (approximately $2½ billion per year for each interest rate point). The result is to widen the deficit which, of course, is one of the reasons why interest rates are high in the first place! Another Catch 22 deals with the financial markets. High interest rates depress the stock market, which makes more companies candidates for takeovers, thus boosting loan demand. Strong loan demand keeps interest rates high, too. Finally, high interest rates have caused a shift in corporate borrowing from the long-term markets to the short-term markets as businessmen wait for rates to come down. But this very shift has kept interest rates in the short-term markets high because of supply and demand. As long as short-term rates remain high, long-term rates stay up as well as bond dealers seek to minimize the cost of borrowing to purchase these bonds (see Chart IV, Page 4).

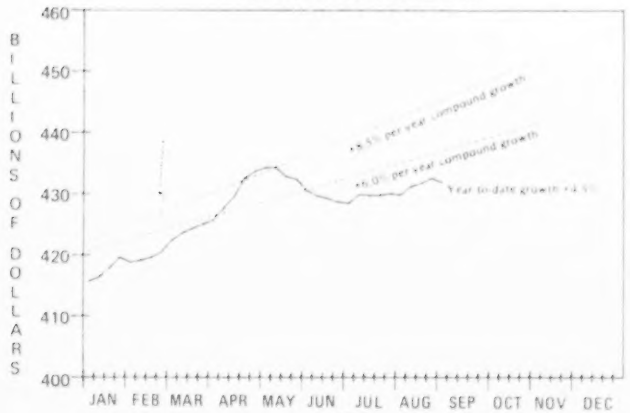
. . . Causing Considerable Pain . . .

Needless to say, these continuously high interest rates are causing considerable pain. As you can see from Chart II, business failures are rising rapidly. And since there appears to be a six-month lag between a change in interest rates adjusted for inflation and the time when companies feel their full impact, you can see where even further increases in bankruptcies are likely. Although concentrated in such well-known interest-sensitive sectors as automobiles and homebuilding, corporate casualties are beginning to occur in a number of other industries, both related and unrelated to these two key sectors. For example, many mutual savings banks and savings and loan associations are in deep trouble because of high interest rates while the nation's farmers are increasingly threatened by the vicious combination of high money costs and low prices for most farm commodities.

There is other pain as well. The Commerce Department reported this month that businesses not only did not step up their plans to invest in new plants and equipment as a result of the passage of the President's economic program—they actually cut

them back over the summer. Along with reduced levels of inventory building, this will keep industry from expanding capacity and jobs as the Administration had hoped. Of course, many holders of financial market instruments have been hurt by the plunge in prices of both equities and fixed-income investments.

CHART III
MONEY SUPPLY, M1-B
FOUR WEEK MOVING AVERAGE



. . . And Warnings From Washington

Not surprisingly, the failure of interest rates to come down has provoked negative reactions from Washington. Several key Administration officials — including the President, himself — have said that interest rates are too high, they are hurting and they ought to come down. Earlier this month some Congressional leaders threatened to seek new restrictions on the financial markets, such as credit controls and a windfall profits tax on interest rates as a means of cajoling the financial markets to lower money costs. There was also a suggestion to modify the independence of the Federal Reserve.

There is much irony in this latest turn of events. This is because this Administration and many of its colleagues in the Congress are supposedly champions of free markets. They should know better than to try to influence the markets by words rather than deeds — especially since it has been the actions of past Administrations and past Congresses in failing to observe the rules of fiscal prudence and economics by running large and continuous deficits in the Federal budget that have been responsible for our current plight.

The Fed Should Ease . . .

Nevertheless, this gridlock in the financial markets must be broken. There has to be a way of bringing interest rates down relatively quickly. Because of repeated disappointments over promises by various Administrations and the Congress, the markets are unlikely to be assuaged anytime soon—unless President Reagan slashes the budget deeply. As I noted before, fiscal year 1981 is drawing to a close much more deeply in deficit than Washington originally estimated, while the same process of underestimating the flow of red ink appears to be well underway for fiscal years 1982 and beyond. Even if the President makes additional cuts in the budget, it will be some time before the markets will be able to determine whether or not these cuts have succeeded in bringing down the deficit.

Until fiscal policy is shaped up, the Federal Reserve must step in to provide at least partial relief by easing monetary policy. To be sure, the Fed has already loosened somewhat its grip on the credit reins. The key Federal funds rate — which may no longer be an objective of Fed policy but certainly reflects it — has come down from 20 per cent in July to 15½ per cent by mid-September. The Fed has accomplished this by making reserves more available to the banking network. Adjusted nonborrowed reserves have increased at a six per cent annual rate since June, after falling at an 11 per cent annual rate from March. It has shown up in the behavior of the money supply MI-B. Reflecting the earlier tightening in nonborrowed reserves, MI-B fell from April to June; it has since gone up, but so slightly that most people have not been aware of it. I think the Fed must be bolder. However, it can do so only with proper justification. Otherwise, as I said in the July Economic Report, any decline in interest rates would only be temporary and would be followed by even higher rates of interest as inflation psychology reached a new higher level.

M-2 AND SELECTED COMPONENTS

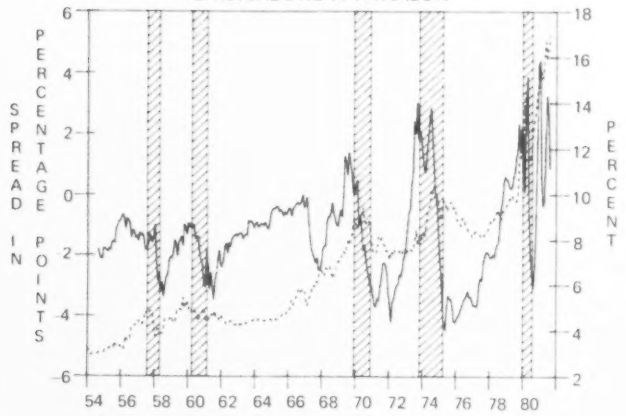
(billions of dollars)

	Dec 1980	% of Total	July 1981	% of Total	Dec-July % Change
M-2 Total	1,669.4	100.0	1,760.0	100.0	+ 5.4
Currency	116.1	7.0	120.9	6.9	+ 4.1
Demand Deposits	267.4	16.0	236.6	13.4	− 11.5
Other Checkable Deposits (NOW Accounts)	28.1	1.7	69.0	3.9	+ 145.6
Money Market Mutual Funds	75.8	4.5	134.3	7.6	+ 77.2
Savings Deposits	393.0	23.5	349.0	19.8	− 11.2
Small-denomination Time Deposits	756.8	45.3	811.6	46.1	+ 7.2

I think I can provide the justification. For the past few months, the Federal Reserve has shifted its focus from the narrowly defined money supply MI-B to two broader definitions: M-2 and M-3. The money managers apparently believe that MI-B understates the amounts of transactions funds available in the system in view of the growth of money market mutual funds, overnight repurchase agreements and other instruments which are not part of MI-B. But no one knows how much of M-2 and M-3 represents transactions balances and how much represents savings which are unlikely to be tapped on a daily basis. The fact that there is widespread speculation that the money market mutual funds will be the big losers when the All

Savers accounts take effect October 1 suggests that this component, which as you can see from the table has contributed significantly to M-2 growth this year, might very well consist largely of savings-type deposits. This is because funds put into All Savers certificates must be left untouched for one year.

CHART IV
SPREAD BETWEEN FEDERAL FUNDS RATE
AND AA UTILITY RATE (LINE)
VS. ACTUAL UTILITY RATE (DOT)



. . . To Break The Gridlock

Because of these and other uncertainties, I think the Fed should shift its focus back to MI-B as an instrument of monetary policy and justify it to the marketplace. The justification is simple: MI-B is the best measure of transactions funds in the economy and, as Chart III demonstrates, it is plainly growing too slowly. Because of this, there is an insufficiency of credit to provide enough funds to cover both Washington's budget deficit and economic growth. Since Washington always gets the funds it needs, economic growth is being shunted aside with the consequences I noted above. Whether right or wrong, the financial markets are monetarist-oriented, so any easing of Fed policy must be acceptable to this belief.

If the Fed eases further, the Federal funds rate would come down even more. In turn, this would enable the banks to reduce both their prime and broker loan rates. As the spread between these rates and the rate on bonds turns positive, long-term rates will start falling. Dealers will be less reluctant to accept lower interest rates on bonds they purchase with borrowed money if the interest rates they have to pay on the funds they borrow is equal to or less than the yield they obtain from the bonds, while investors will be attracted by the higher yields.

Once long-term interest rates begin to fall, some of the loan demand now concentrated in the banks or the commercial paper market should begin to shift back to the bond market. Business might seek to "capture" the lower bond interest rates before they disappear as was the case last year. However, at the same time, investment funds may very well move into the bond markets to "lock up" interest rates while they are still high. While under other circumstances these two developments could produce a standoff, continued easing by the Fed until MI-B is within the target bands, along with a tighter fiscal policy should produce further declines in interest rates, both short and long, with the result that the gridlock will be broken.

Some may regard this approach as tricky while others would look upon it as far-fetched. My response would be to paraphrase the remarks of the great entertainer Maurice Chevalier: It ". . . isn't so bad when you consider the alternatives."

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MANUFACTURERS HANOVER

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

OCTOBER 1981

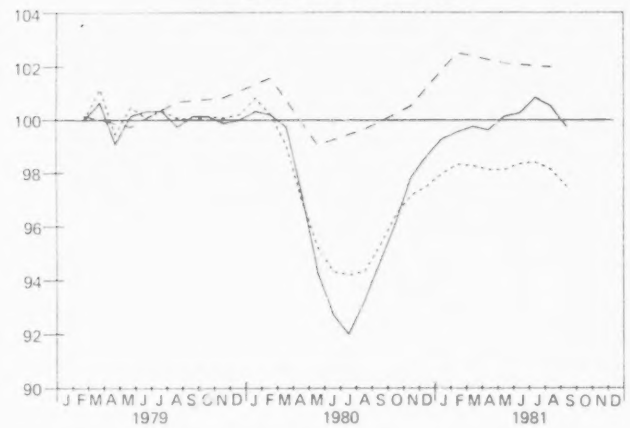
Economic Forecast For 1982

The stagnation that has characterized the U.S. economy since early 1979 has taken a new turn. Whereas business activity rebounded in mid-1979 and mid-1980 following declines in each year's second quarter, it has apparently failed to do so in 1981. After falling at an annual rate of 1-1½ per cent in the second quarter, the gross national product adjusted for inflation fell one half of one percent at annual rates in the third, according to the Commerce Department's preliminary estimates. What is more, since the various monthly and weekly statistics indicate that business activity was weaker at the conclusion of the third quarter than it was at the beginning, it is very likely that yet another decline will occur during the current calendar quarter.

This negative turn of events has prompted a Presidential declaration of recession. In a statement reminiscent of one that Jimmy Carter made back in July of 1979, President Reagan earlier this month voiced his belief that the economy has entered into a recession. Like President Carter's statement, President Reagan's remark is a most unusual admission from an incumbent Administration. Previously, Administrations did not like to talk about recessions—even after they were officially certified by the umpire of the business cycle, the National Bureau of Economic Research. The Bureau has made no such judgment about the most recent decline in economic activity. Indeed, it took the NBER until July of this year to fix the terminal date of last year's recession.

At the risk of being repetitive, I think that the NBER should reconsider its method of dating the business cycle. As I pointed out in the July Economic Report, many consumers and businessmen in the "real world" believe that the recession got under way in early 1979—and is still with us. Certainly, the aggregate measures of economic activity depicted in Chart I would seem to bear this out. The real GNP is only a touch higher today than it was in first-quarter 1979 while industrial production and the coincident indicator index are lower. Plainly, we have been experiencing over much of the

CHART I
REAL GNP (DASH), INDUSTRIAL PRODUCTION (LINE), INDEX OF COINCIDENT INDICATORS (DOT)
FIRST QUARTER 1979 = 100



past three years a definite departure from the business cycles of the past. Since early 1979 the economy has encountered a series of stops and starts, rather than regular, clearly-defined ups and downs in economic activity with their usual effects on interest rates, the rate of inflation and so on.

Given this new environment, it is hardly surprising that economists have had great difficulty in forecasting. Traditional business cycle analysis no longer offers clues to the longevity of a slump or an expansion. Interest rate forecasting—a hazardous undertaking under the best of circumstances—has become virtually impossible without clearly-defined business cycles, not to mention the advent of Federal Reserve's new regime of monetarism. The net result is confusion in the money and credit markets, as well as on the part of consumers, businessmen and policymakers.

The New Energy Equation

What caused this to happen? Why, after decades of regular cyclical ups and downs has the economic rhythm changed? The way I see it, three major developments are responsible. The first has its roots back in 1973-74, when the Organization of Petroleum Exporting Countries slapped an embargo on exports of petroleum to the West, and raised oil prices significantly. Although consumers and business soon adapted to higher-priced

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energy by purchasing smaller cars, insulating their homes and offices, and changing thermostat settings, their enthusiasm for conservation gradually waned as the nominal price of oil held steady in the wake of continued inflation, thereby driving down oil's "real" price.

It took the second "oil shock" of early 1979, that followed in the wake of the revolution in Iran, to change permanently attitudes toward energy use. Those changes resulted in a shift in the basic structure of the U.S. economy. Industries that either used large amounts of energy in the production process or which produced goods that used large amounts of energy soon found themselves in difficulty. Autos were among the first to be affected as consumers sought smaller, energy-efficient vehicles that Detroit was not yet equipped to produce. As a result, those industries that depended heavily on automobiles—the so-called smokestack industries such as steel, copper, rubber, etc.—began to suffer a decline in orders and shipments. Housing was the next to be affected because the increase in energy prices made the cost of running a home significantly higher than in the past, pricing some people out of the market.

On the other hand, industries that either used relatively little energy in the production process or, more importantly, were engaged in the exploration, production, transmission or saving of energy found their fortunes much improved. In other words—the U.S. economy became highly segmented, no longer moving as a monolith, with all industries expanding during good times and contracting during bad times. The economy was able to bounce back from the decline in second-quarter 1979 because the pluses outweighed the minuses. However, overall growth soon slowed down.

Monetarism Becomes a Factor

The next development approached center stage in October, 1979. This was the Federal Reserve's break from its traditional method of conducting monetary policy. Previously, the Fed focused on attempting to stabilize money market conditions by regulating short-term interest rates. In the process, however, it accommodated inflationary shocks to the economy by producing more money than was consistent with real economic growth. This, in turn, led to ever-higher rates of inflation as the economy emerged from the various postwar business cycles, along with ever-higher interest rates. In October, 1979 the Fed began to pay more attention to the money supply and less to money market conditions. It was expected that this monetarist type of monetary policy would result in more fluctuations in day-to-day levels of interest rates. This is because regulating the supply of money without taking into account changes in demand would produce fluctuations in its price in the same way that regulating the price of money by accommodating changes in demand resulted in fluctuations in growth of its supply.

No one was prepared for the amount of volatility that actually occurred in interest rates—especially at the short-term end. Since October, 1979, the month-to-month movement in the key Federal funds rate has averaged approximately seven times the size of the average monthly change in this rate during the previous two years. Because financial market participants became so uncertain over the cost of money, hence their ability to generate a profit on a bank loan, securities investment, etc., they tended to demand higher interest rates to compensate. This spilled over into the long-term markets for reasons I explained in the September Economic Report. And as rates rose in the long-term markets, corporate financing tended to dry up. This, along with the high cost of money for those that did borrow in the bond markets discouraged business investment, leading to declines in another wave of industries—those dealing with capital goods. Needless to say, high short-term rates once again affected the housing and automobile sectors, sending them down in early 1980 for the second time in two years.

For a while, most companies were able to adapt to these circumstances because the "real" cost of borrowing was negligible. Monetarism notwithstanding, nominal interest rates were barely above the rate of inflation in the opening months of 1980—and plunged well below the rate of inflation in the wake of the steep decline in economic activity in last year's second quarter and the Fed's effort to arrest this by injecting reserves into the banking system. This was subsequently followed by a rise in interest rates as the Fed sought to reverse the rise in money growth that followed.

Interest rates remained high through the beginning of 1981 even though the rate of inflation had begun to slow under the pressure of a slower-growth economy, flatness and eventual decline in oil prices, and falling prices of food and industrial commodities. This resulted in a rise in the "real" cost of borrowing money to levels not seen in recent memory. The belief that adhering to monetarism would eventually bring lower rates of inflation and interest, along with the hoped-for positive results of the Administration's planned economic program encouraged people to overlook these high real costs of borrowing money. Unfortunately, many found that they could not—witness the 40 percent jump in business failures thus far in 1981.

Fiscal Policy Pushes Business Down

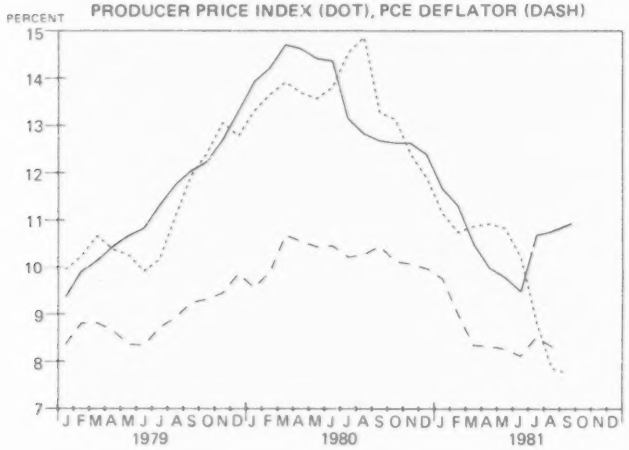
The economy thus managed to adapt to monetarism as well. After falling sharply in second-quarter 1980, the aggregate measures of business activity subsequently bounced back. However, the third development, the Administration's fiscal program, was apparently too much for the economy to bear. This is ironic, because it was intended to improve business. The cuts in personal and business taxes engineered by the White House were supposed to boost expectations, stimulate savings, and encourage business investment in new plants and equipment. Accompanied by significant increases in defense spending, with only belated cuts in nondefense spending, this provided a hefty dose of fiscal stimulus

to the economy. It was supposed to generate optimism on Wall Street as well as Main Street, but when people got down to the arithmetic, they concluded that it could not work.

Cutting taxes and increasing defense spending before putting into effect offsetting reductions in nondefense outlays amounted to a substantial widening of the budget deficit—regardless of what their classroom results might have suggested. Since the Federal Reserve has adapted a policy of trying to slow the growth of the money supply to noninflationary proportions, Washington's increased financing needs could only come at the expense of funds available to the private sector. Total Federal borrowing, direct and guaranteed, has already risen at a substantial rate over the years, accounting for a bigger and bigger share of all the funds raised in the financial markets. The belief that this trend will continue finally put the kibosh on economic activity, preventing business from recovering from this year's downturn.

The road ahead looks equally rocky. It will take a long time for the economy to adjust fully to the changed energy environment. Until it does, those industries that have been negatively affected by the sudden jump in the price of energy will continue to be so. More important, the combination of a loose fiscal policy and a tight monetary policy will prevent the private sector from mounting any kind of a sustained, healthy recovery.

CHART II
12-MONTH PERCENT CHANGE IN
CONSUMER PRICE INDEX (LINE),
PRODUCER PRICE INDEX (DOT), PCE DEFLATOR (DASH)



There is one bright spot, however, and that is the prospect for a further improvement in the rate of inflation. As you can see from Chart II, the three major price indexes have decelerated noticeably from their early 1980 highs. The pain of economic slump, by making it more difficult for business to raise prices and labor to raise wages, will ensure a further slowing in the rate of inflation.

The more financial participants see inflation dampened, the more likely they are to believe that it is "permanent" and the sooner interest rates will come down. While there is always the possibility that huge Federal financings will interrupt this decline and push rates up for a while, I don't look for rates to rise to new record highs. This is not necessarily because I have any great faith in the ability of Washington to get its budget deficit down. Rather, I feel that interest rates at present levels are already proving onerous to the private sector and, unless accompanied by a sudden turnaround in inflation, any increase would simply cause more companies to go under, thereby reducing the demand for funds and offsetting the increased pressure from the Federal government.

Recommendations

In the July Economic Report, I called for a tightening of fiscal policy to reduce the pressure on the money and credit markets without the Fed resorting to monetary ease. Events of the last three months suggest that such a development is more important than ever. I think the Administration should postpone the second-stage tax cut now scheduled to take effect July 1, 1982. What is more, I think other sources of revenue should be looked for, including a value added tax. I think the Administration should be more realistic about how much it is going to get in the way of further cuts in nondefense spending while defense spending is permitted to grow. I do believe in tax incentives to encourage business investment, but at the moment these should be limited to those dealing with new energy-saving machines, processes, etc.

On the monetary side, I think the Fed should continue its recent move toward somewhat easier money. This is not to say that its growth targets for the various money and credit aggregates should be elevated. Rather, in the case of the money supply M1-B, the Fed should try to get this aggregate to grow a little faster, so that it will be within the target range, rather than below it.

It is clear that a loose fiscal policy combined with tight money can only serve to depress economic activity and not the reverse. No matter what incentives may be written into the tax law for individual saving and business investment, when the Federal government crowds out the private sector by driving interest rates up, throwing businesses into the bankruptcy courts and individuals out of work, it is clear that neither will take place.

Perhaps the time has come to try the opposite—that is, a tight fiscal policy and a *relatively* easy monetary policy. This will reduce the pressure on the credit markets coming from Washington while at the same time making more funds available for individuals and business to use in their buying and investment decisions. Provided that the Fed doesn't go overboard with growth in money, I think this might lead to a healthier economy. There will be plenty of time to talk about reducing tax burdens once the budget gets into balance and stays there. For the moment, however, cutting the budget deficit must be the first priority and it must be done quickly. H

October, 1981

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< ACTUAL					PROJECTED >								
	YEAR 1980		1981				YEAR 1981		1982				YEAR 1982	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2626.1**	**8.8**	2853.0	2885.8	2947.0	3003.0	**2922.2**	**11.3**	3055.7	3121.1	3195.9	3266.4	**3159.8**	**8.1**
GNP: $72	**1480.7**	**−0.2**	1516.4	1510.4	1508.2	1500.7	**1508.9**	**1.9**	1500.8	1507.8	1515.3	1519.0	**1510.7**	**0.1**
% Change, Annual Rates	**−0.2**		8.6	−1.6	−0.6	−2.0	**1.9**		0.0	1.9	2.0	1.0	**0.1**	
Consumption	**1672.7**	**10.7**	1810.1	1829.1	1888.6	1937.7	**1866.4**	**11.6**	1978.2	2020.8	2066.5	2116.3	**2045.5**	**9.6**
Durables	**211.9**	**−0.2**	238.3	227.3	240.0	246.2	**237.9**	**12.3**	249.7	256.2	259.3	269.1	**258.6**	**8.7**
Non-Durables	**675.7**	**12.2**	726.0	735.3	750.1	763.2	**743.6**	**10.1**	774.8	787.9	806.8	820.6	**797.5**	**7.2**
Services	**785.2**	**12.8**	845.8	866.5	898.6	928.3	**884.8**	**12.7**	953.7	976.7	1000.4	1026.5	**989.3**	**11.8**
Investment	**395.3**	**−4.9**	437.1	458.6	449.8	435.9	**445.4**	**12.7**	439.0	459.4	478.1	486.6	**465.8**	**4.6**
Non-Residential	**295.9**	**5.8**	315.9	324.6	330.8	332.9	**326.1**	**10.2**	336.4	342.6	348.8	353.0	**345.2**	**5.9**
Producers Durable Equipment	**187.1**	**2.0**	198.7	201.5	203.1	203.1	**201.6**	**7.7**	205.0	209.7	214.0	216.0	**211.2**	**4.8**
Structures	**108.8**	**13.0**	117.2	123.1	127.8	129.9	**124.5**	**14.4**	131.4	132.9	134.8	137.0	**134.0**	**7.6**
Residential	**105.3**	**−11.2**	116.7	110.7	101.4	99.2	**107.0**	**1.7**	103.7	107.8	118.9	122.1	**113.1**	**5.7**
Inventory Changes	**−5.9**		4.5	23.3	17.6	3.8	**12.3**		−1.1	8.9	10.5	11.5	**7.4**	
Net Exports	**23.3**		29.2	20.8	18.0	17.3	**21.3**		14.3	9.9	7.9	11.3	**10.9**	
Government Purchases	**534.7**	**12.9**	576.5	577.4	590.5	612.1	**589.1**	**10.2**	624.1	631.0	643.4	652.2	**637.7**	**8.2**
Federal Defense	**131.7**	**18.4**	145.2	148.2	154.6	168.4	**154.1**	**17.0**	172.7	174.9	178.2	180.0	**176.5**	**14.5**
Federal Civilian	**67.2**	**18.5**	76.4	71.3	73.0	74.5	**73.8**	**9.8**	76.3	78.1	76.9	75.7	**76.7**	**4.0**
State & Local	**335.8**	**9.8**	354.9	357.9	362.9	369.2	**361.2**	**7.6**	375.1	378.0	388.3	396.5	**384.5**	**6.4**
Final Sales: $72	**1483.6**	**0.7**	1517.8	1499.6	1497.9	1499.1	**1503.6**	**1.3**	1501.4	1504.0	1511.0	1514.3	**1507.7**	**0.3**
% Change, Annual Rates	**0.7**		6.9	−4.7	−0.5	0.3	**1.3**		0.6	0.7	1.9	0.9	**0.3**	
GNP Price Index (1972 = 100)	**177.4**	**9.0**	188.1	191.1	195.4	200.1	**193.7**	**9.2**	203.6	207.0	210.9	215.0	**209.1**	**8.0**
% Change, Annual Rates	**9.0**		9.8	6.4	9.4	10.0	**9.2**		7.2	6.8	7.7	8.1	**8.0**	
PCE Deflator (1972 = 100)	**178.9**	**10.2**	188.5	191.5	195.7	199.5	**193.8**	**8.3**	203.1	206.5	210.4	213.8	**208.4**	**7.6**
% Change, Annual Rates	**10.2**		8.0	6.5	9.1	7.9	**8.3**		7.5	6.9	7.7	6.7	**7.6**	
Consumer Price Index (1967 = 100)	**247.0**	**13.5**	263.6	268.4	276.1	283.2	**272.8**	**10.5**	287.7	292.8	298.6	303.8	**295.7**	**8.4**
% Change, Annual Rates	**13.5**		10.8	7.5	11.9	10.7	**10.5**		6.4	7.3	8.2	7.1	**8.4**	
Total Personal Income	**2160.3**	**11.1**	2319.7	2368.5	2440.0	2513.7	**2410.5**	**11.6**	2561.1	2610.4	2676.3	2728.4	**2644.0**	**9.7**
Disposable Personal Income	**1821.7**	**11.0**	1947.8	1985.6	2040.1	2099.1	**2018.1**	**10.8**	2137.2	2175.1	2259.9	2300.5	**2218.2**	**9.9**
Savings Rate	**5.6**		4.6	5.4	4.9	5.2	**5.0**		5.0	4.6	6.1	5.6	**5.3**	
Employment Rate	**57.7**		57.7	58.0	57.7	57.4	**57.7**		57.3	57.6	57.8	58.0	**57.7**	
Unemployment Rate	**7.1**		7.3	7.4	7.2	7.9	**7.5**		8.3	8.0	8.1	8.1	**8.1**	
Indus. Production (1967 = 100)	**147.0**	**−3.6**	151.8	152.5	153.1	150.6	**152.0**	**3.4**	150.0	151.5	152.7	152.2	**151.6**	**−0.3**
Housing Starts (000)	**1303.5**	**−24.0**	1390.7	1176.3	966.3	952.1	**1121.4**	**−14.0**	1154.5	1222.5	1323.8	1195.6	**1224.1**	**9.2**
Domestic Auto Sales (000)	**6629.1**	**−19.5**	7400.0	5566.7	6933.3	6309.8	**6552.4**	**−1.2**	6730.6	7136.4	7147.5	7273.6	**7072.0**	**7.9**
Corporate Pre-Tax Profits	**245.5**	**−3.8**	257.0	229.0	215.0	211.4	**228.1**	**−7.1**	209.6	218.8	224.0	227.3	**219.9**	**−3.6**
− Taxes	**82.4**	**−3.0**	87.7	76.4	69.4	68.2	**75.4**	**−8.4**	67.1	70.4	72.2	73.4	**70.8**	**−6.2**
Net Profits	**163.2**	**−2.7**	169.2	152.7	145.6	143.2	**152.7**	**−6.5**	142.5	148.3	151.8	154.0	**149.2**	**−2.3**
− Dividend Payments	**56.0**	**11.7**	59.6	62.0	64.8	66.6	**63.3**	**13.0**	67.8	68.7	70.4	73.0	**70.0**	**10.6**
Undistributed Profits	**107.2**	**−8.9**	109.6	90.6	80.8	76.5	**89.4**	**−16.6**	74.7	79.6	81.4	81.0	**79.2**	**−11.4**
+ Depreciation	**158.3**	**13.4**	172.8	179.9	187.2	192.4	**183.1**	**15.7**	202.5	205.5	208.6	212.1	**207.1**	**13.1**
− Inventory Profits	**45.6**	**7.1**	39.2	24.0	27.2	20.9	**27.8**	**−39.0**	27.7	33.3	34.6	30.7	**31.6**	**13.4**
Net Cash Flow	**219.8**	**2.4**	243.2	246.5	240.8	248.0	**244.6**	**11.3**	249.4	251.8	255.4	262.4	**254.8**	**4.1**